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STATE OF ILLINOIS

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HEARING EXAMINERS' PROPOSED ORDER

By the Commission:

I. INTRODUCTION

In its Order entered on October 11, 1994, the Illinois Commerce Commission ("Commission") scheduled a five-year review to determine whether the Alternative Regulation Plan ("Plan") it authorized for Ameritech Illinois was meeting with the Commission's goals and statutory requirements. (Order, Docket 92-0448/93-0239 (consol.) ("Alt Reg Order")). Docket 92-0252 is that review proceeding. It was consolidated with Docket 98-0335 whereby AI requested rate restructuring and with Docket 00-0764 wherein CUB and the AG seek rate relief.

Pursuant to notice given in accordance with the law and the rules and regulations of the Commission, this matter came on for hearings before duly authorized Hearing Examiners of the Commission at its offices in Chicago, Illinois.

The following parties intervened or entered appearances, by their respective counsel, in the instant proceedings: Ameritech Illinois, ("the Company" or "AI"), Staff of the Commission ("Staff"), United States Department of Defense ("DOD"), McLeodUSA Telecommunications Services, Inc. ("McLeod"), AT&T Communications of Illinois, Inc. ("AT&T"), Cable Television & Communications Association of Illinois ("Cable"), City of Chicago ("City"), Citizens Utility Board ("CUB"), Cook County State's Attorney's Office ("CCSAO" or "Cook County"), People of the State of Illinois ("AG") (CUB, CCSAO and the AG are collectively referred to as "GCI").

An evidentiary hearing was held in these consolidated proceedings from February 13, 2001 through February 23, 2001.

AI presented the testimony of the following witnesses: David H. Gebhardt; Thomas O'Brien; Mark E. Meitzen; William E. Avera; Rick Jacobs; Michael J. Barry; Timothy Dominak; William C. Palmer, Robert G. Ibbotson; David Sorenson; John Hudzik and Robert G. Harris.

Testimony on behalf of Staff was provided by: Robert Koch; Mary Everson; Diana Hathhorn; Bill Voss; Jeffrey Hoagg; James Zolnierik; Genio Staranczak; Judith R. Marshall; Sam McClerren; Mark A. Hanson; Alcinda Jackson; Joy Nicdao-Cuyugan; Alan S. Pregozen and Bud Green.

DOD presented the testimony of Harry Gildea. McLeod presented the testimony of Rod Cox. Cate Conway Hegstrom testified on behalf of AT&T.

The following witnesses testified on behalf of GCI/City: Ralph C. Smith; William Dunkel; Roxie McCullar; Thomas M. Regan; Lee L. Selwyn and Charlotte F. Terkeurst. Dr. Selwyn also testified for the City on certain issues.

Each of the witnesses identified above was available for cross-examination at the hearings. The record was marked "Heard and Taken" on March 2, 2001.

Initial Briefs were filed by DOD; CCSAO; People; CUB; City; AI; AT&T; McLeod and Staff. Reply Briefs were filed by Staff; DOD; GCI; AT&T; AI; Cable and McLeod.

Partial Draft Orders were presented by AI, GCI, AT&T and McLeodUSA.

The Hearing Examiners Proposed Order in these consolidated dockets was issued on May 22, 2001.

Background

In 1994, the Commission entered an Order whereby AI would be regulated not under traditional rate of return regulation but rather by an Alternative Regulation Plan

("Plan") which caps its non-competitive rates and not its earnings. ("Alt Reg Order") In approving the Plan, the Commission had to make seven affirmative findings under Section 13-505.1 and further consider the policy goals set out in Section 13.501.1(a) and the provisions of Section 13-103. Since the plan was new and untested, the Commission ordered that there be a comprehensive review at the end of a five-year period to determine whether, and to what degree, it has met the settled statutory and regulatory goals.

The instant proceeding arose with Ameritech's March 31, 1998 filing of an application for review in compliance with the Commission's direction in the Alt Reg Order. (See, Alt Reg Order at 94-95). It is the first review of an alternative regulatory plan for a telephone company and the first review of Ameritech's Plan. In its Application, AI was required to address ten issues which set the scope of the instant review. It submitted the requested information in its direct testimony for this proceeding.

We agree with Staff that the analysis here is a historical one which seeks to assess how the plan has functioned up to now. (Staff Initial Brief at 28) To be sure, certain of the items only required a simple listing of changes occurring during the plan (e.g., items e, f, g, h), while others are more substantive and forward-looking, such as whether the adjustment factor in the price cap index should be modified and whether the plan has met each of the established statutory and regulatory goals (c, j). (See Alt Reg Order at 95, 179-192)). Some of the issues AI addressed were the subject of dispute and further analysis while others were primarily informational in nature.

The issue at this stage is whether the Plan, as established in 1994, has performed in accordance with both the statutory goals outlined in the Act and the regulatory goals and expectations set out in the Alt Reg Order.

II. THE 10 POINT REVIEW - Commission Specific Issues

Here we examine the ten specific items which AI was required to address in its application for review of the Plan. As we review the information provided, other evidence and arguments, we will be considering if the Plan should be continued.

(a) Does the inflation index and the manner in which it is applied provide an adequate reflection of economy-wide inflation?

AI's Position

AI maintains that the Gross Domestic Producer Price Index ("GDPPI") provided an adequate reflection of economy-wide inflation during the term of the Plan. According to AI, it is a widely accepted measure of economy-wide inflation for all goods and services produced by the U.S. economy and is used by the FCC and a number of state commissions in their price cap plans. At the time of the Plan's adoption in 1994, the fixed-weight version of GDPPI was the accepted and published inflation measure. In addition, a fixed-weight methodology was used to calculate economy-wide TFP and input price growth for purposes of establishing the X factor.

Subsequent to 1994, however, the Bureau of Economic Analysis of the U.S. Department of Commerce replaced the fixed-weight GDPPI with the chain-weighted GDPPI as the official measure of inflation. In addition, the Bureau of Labor Statistics has adopted chain-weighted measures in constructing economy-wide TFP, which also means that economy-wide input price growth is calculated on a chain-weighted basis.

Accordingly, AI maintains, the chain-weighted version of GDPPI should be used in the price index formula on a going-forward basis, along with chain-weighted versions of all other components of the X factor.

Staff's Position

In the Alt Reg Order, the Commission observed that a price regulation plan, such as the one at issue here, generally has at least two principal components: a measure of economy-wide inflation, and an offset to the inflation measure which measures productivity. (Alt Reg Order at 20). For that purpose, the Commission adopted the GDPPI as the measure of economy-wide inflation to be used in setting the price cap under the Plan. (Id. at 36.)

It further directed Ameritech to use a specific form of the GDPPI, called the "fixed weight" GDPPI, in its annual filings to date. The measure is produced by the Bureau of Economic Analysis ("BEA") and is revised periodically, with an annual revision occurring in August of each year. Staff tells us that this measure came into question in past annual filings due to the inconsistencies resulting from these periodic restatements in GDPPI data in a given year.

Staff provides the following example of how restating the GDPPI data can impact the amount of rate reductions in a given year. In Ameritech's Fourth Annual Filing, it reported the 1997 4th quarter GDPPI to be 114.4. In the Fifth Annual Filing, however, Ameritech reported the 1997 4th quarter GDPPI to be 113.4. According to Staff, the restatement of the GDPPI allowed AI to double-count 0.9% in inflationary change between the two filings. As a result, Staff claims, Illinois ratepayers were denied $9,248,761 in rate reductions in 1999.

Staff recommends that we discard the fixed weighted GDPPI in favor of another measure, i.e., the chain weight GDPPI. According to Staff, this chain weighted GDPPI is not restated in the same manner as the fixed weight GDPPI and, if adopted, would alleviate the problems it has described.

AG's Position

The AG contends that the manner in which the GDPPI has been applied has raised some issues. The BEA restates the GDPPI periodically, and if the effect of that restatement is not reflected in the price cap formula, AI can double count a portion of inflationary change to its benefit. Because these restatements can have a "drastic effect on GDPPI data and their consistency from year to year," the AG would have the Commission make appropriate adjustments to the annual rate filing process to correct this problem and insure consistency. In this proceeding, GCI witness Lee Selwyn proposed that the Commission adopt the chain-weighted GDPPI measure in the price index formula. Both Staff and Ameritech witnesses agreed.

Commission Analysis and Conclusion

All parties agree that the chain weighted GDPPI is now the appropriate measure of inflation. Further discussion follows in another section of this Order.

(b) An assessment of productivity gains for the economy as a whole, for the telecommunications industry to the extent data are available, and for Illinois Bell during the period that the alternative regulatory framework has been in place, and whether the adopted general adjustment factor should be modified.

AI's Position

AI notes that the Commission's 1994 Order established an X factor of 4.3%. It consisted of a productivity differential of 1.3%, an input price differential of 2.0% and a 1.0% consumer productivity dividend. The productivity differential and input price differential were based on a study of Ameritech Illinois' own historical productivity and input price performance over the 1984-91 time period. (Alt Reg Order at 21-22, 40).

AI submits that in using the most recent data released by the Bureau of Labor Statistics, the U.S. economy's productivity growth over the 1992-98 period was 1.0 percent and economy-wide input price growth was 3.0 percent.

i. Ameritech Illinois - Specific Results

AI witness Dr. Meitzen updated the Ameritech Illinois TFP study which the Commission relied on in 1994. His testimony demonstrated that between 1984-91, AI's TFP growth averaged 2.2% and economy-wide TFP growth was 0.9%, for a TFP differential of 1.3%. Over the 1992-99 period, Ameritech Illinois' output growth averaged 4.6%, input growth averaged 0.5% and TFP growth averaged 4.2% annually. Based on the current BLS data referenced above, this results in a current TFP differential of 3.1% and an input price differential of 0.5%, for an X factor of 3.5%. (Am. Ill. Ex. 2.2, p. 5).

ii. Local Exchange Industry Results

To develop local exchange industry TFP results, AI witness Dr. Meitzen used the Total Factor Productivity Review Plan ("TFPRP") model, developed by the United States Telecom Association ("USTA") in conjunction with his consulting firm, which measures TFP growth for the local exchange carrier industry. The TFPRP is based on the same methodology as the Ameritech Illinois-specific TFP studies, is updated periodically and, currently, model results are available through 1998. For the 1992-1998 period, the TFPRP calculates average annual output growth of 4.7 percent, average annual input growth of 1.3 percent and average TFP growth of 3.4 percent annually for the LEC industry. Using the above referenced BLS data, the industry TFP differential is 2.4 percent, and the input price differential is 0.9%, for an X factor of 3.3%. (AI Ex. 2.2, pp. 3-4).

Staff's Position

Staff explains that the general adjustment or "X" factor in the price cap formula consists of three elements: (1) a productivity differential; (2) an input price differential; and (3) a consumer dividend. The productivity differential measures the difference between telecommunications total factor productivity gains and overall economy total factor productivity gains. The input price differential measures the difference between telecommunications input prices and economy-wide input prices, and the consumer dividend is a judgmental factor imposed by the Commission based upon its expectations regarding gains that arise from technological and/or regulatory change that the Commission anticipates.

Staff notes that in 1994, the Commission set the productivity differential at 1.3%, the input price differential at 2.0% and the consumer dividend at 1.0% (Alt Reg Order at 38). This decision was based on the Commission's analysis of Ameritech's productivity and input price performance *vis a vis* the economy as a whole and its expectations for the future. At the time of the Alt Reg Order, i.e., 1994, industry productivity and input price data was unavailable.

In this proceeding, Staff proposes that both productivity and input price differentials be based on industry rather than Ameritech-specific data, a proposition to which GCI witness Dr. Selwyn and Ameritech witness Dr. Meitzen concur. This is primarily because the "X" factor should replicate as near as possible what would occur in a competitive market, and pricing in a competitive market closely follows industry productivity and input price averages.

Consequently, Staff recommends that the Commission adopt a productivity differential of 2.3%. This recommendation is based on the results of the United States Telecom Association ("USTA") productivity study, filed as attachments to the testimony of Ameritech witness Mark E. Meitzen. (*See* AI Ex. 2.1, Attachment 2.) In addition, Staff advocates adoption of an input price differential of 1% based upon figures filed in the same attachment. Finally, Staff proposes a consumer dividend of 1% which fulfills the requirement under Section 13-506 (b)(5) of the Public Utilities Act that an alternative regulation plan "…specifically identifies how ratepayers will benefit from any efficiency gains, cost savings arising out of the regulatory change and improvements in productivity due to technological change." 220 ILCS 5/13-506(b)(5). In total, therefore, Staff recommends an "X" factor of 4.3%.

AG's Position

In establishing the price index, the AG maintains, the Commission sought to capture the "competitive outcome" in which industry productivity improvements and cost conditions are flowed through to consumer prices. It adopted a 4.3% X factor, consisting of a 3.3% productivity factor and a 1% consumer dividend, which is subtracted from the GDPPI inflation rate to determine the percentage amount of aggregate rate increases or decreases under the price index plan, subject to service quality performance and exogenous factor adjustments. The 3.3% productivity factor was intended to mirror the "historical differentials between economy-wide and Illinois Bell input prices." Id. at 39. The 1% consumer dividend was based on the Commission's expectation that AI would exceed the 3.3% productivity factor, and that consumers should benefit by adjusting AI's rates by this additional 1%. (Alt. Reg. Order at 39).

The AG refers to GCI witness Dr. Selwyn's testimony indicating that the X factor, as applied, failed to capture a reasonable portion of AI's productivity. (GCI Ex. 3.0 at 22-23.) To test the effectiveness of the X factor, the AG states, Dr. Selwyn calculated what productivity factor would have resulted in AI earning the authorized rate of return of 11.36%. His "implicit X-factor" analysis showed that AI's actual productivity during the course of the plan was 11.06%. According to the AG, this shows that the 4.3% offset has been unreasonably low and that ratepayers have not received a reasonable portion of the productivity savings achieved during the course of the plan.

The AG notes Dr. Selwyn's testimony, that the insufficiency of the 4.3% X factor is also demonstrated by AI's reported earnings of 19.15% for intrastate operations (later reduced to 18.82%) and 23.89% for total company operations for 1999. AI's and Ameritech's reported earnings, compared with FCC ARMIS data for the other Bell Operating Companies, ("BOCs"), shows a great disparity between Illinois Bell, Ameritech and other BOCs. Indeed, the AG claims, AI's return on rate base is almost as high or higher than the BOCs overall return on equity, and Ameritech's own reported return on equity is several hundred basis points higher than the other BOCs return in every year except 1996. These notably high returns on both Illinois rate base and Ameritech stockholder equity, the AG claims, are strong evidence that the X factor has been unreasonably low and that ratepayers have been paying excessive rates as a result.

The AG also notes that the FCC has adopted a 6.5% adjustment factor, or a "rate reduction factor," as a result of the "CALLS" settlement proposed by the BOCs, including AI's parent SBC. Although this 6.5% adjustment factor does not reflect all of the annual cost savings identified in this docket, the AG maintains that it is a more accurate adjustment that will return a reasonable amount of savings to consumers while preserving the efficiency incentives that are part of the price cap plan.

According to the AG, the implicit X factor analysis, AI's extraordinarily high rate of return on rate base, and the fact that AI, Ameritech and SBC proposed a 6.5% rate reduction adjustment in the federal jurisdiction, all demonstrate that the 4.3% X factor was understated and must be adjusted upward. In their Joint Reply Brief, the GCI/City assert that AI has achieved efficiencies well beyond the 4.3% x-factor.

Commission Analysis and Conclusion

The Commission notes that this item raises a dispute which will be subject to analysis in another section of this Order.

(c) Whether the adopted monitoring and reporting requirements should be retained or adjusted.

AI's Position

For its part, Ameritech Illinois proposes to streamline the monitoring and reporting requirements.

Staff's Position

Staff notes that Section 13-506.1 (d) of the Public Utilities Act ("PUA") provides, in relevant part, that:

> Any alternative form of regulation granted for a multi-year period under this Section shall provide for annual or more frequent reporting to the Commission to document that the requirements of the plan are being properly implemented.

In accordance with this statute, Staff claims, the Commission cannot extend the Plan without also retaining some type of monitoring and reporting requirements. Staff further asserts that the information supplied by Ameritech pursuant to such reporting requirements is valuable to the Commission, the Staff, and the public in determining whether Ameritech is complying with the conditions of the Alternative Regulation Plan.

Currently, in its annual price cap filing, Ameritech is required to report on the following:

(1) total Company and Illinois jurisdictional rate base for the preceding calendar year adjusted to reflect regulatory treatment ordered in Dockets 92-0448/93-0239;

(2) total Company and Illinois jurisdictional operating revenue and expenses for the preceding calendar year adjusted to reflect the regulatory treatment ordered in Dockets 92-0448/93-0239;

(3) other income and deductions, interest charges, and extraordinary items for the preceding year (with explanations);

(4) preceding calendar end-of-year capital structure;

(5) calculated total Company and Illinois jurisdictional return on net utility rate base and total Company return on common equity;

(6) statement of Sources and Applications of Funds for the preceding calendar year;

(7) description of proposed projects and amounts to be invested in new technology (regarding the Company's $3 billion infrastructure investment) for the current calendar year and a comparison with the actual projects and amounts invested in new technologies during the preceding calendar year;

(8) calculation of the current price cap index and actual price indexes including the formulas used, the inflation factor and its source, the general adjustment factor, the exogenous factor and a description of its calculation, and the service quality component and a description of its calculation;

(9) a description of new services offered in the preceding calendar year, including the price of each and its effect on the calculation of API;

(10) demand growth by revenue basket in the preceding calendar year;

(11) summary of price changes initiated under the Alternative Regulatory Plan in the preceding calendar year;

(12) a demonstration that Section 13-507 of the Act has been complied with during the preceding calendar year;

(13) a summary report on Ameritech's quality of service during the preceding calendar year; and

(14) a summary report on the exogenous events that affected the exogenous factor of the price cap index formula.

(See, Alt. Reg. Order, Appendix A at 7-10).

Staff recommends that the Commission order the reporting and monitoring requirements to be continued, notwithstanding any objections. According to Staff, the reports are intended to document that the requirements of the plan are being properly implemented such that every requirement or condition of the alternative regulation plan should be addressed in these reports. Otherwise, the Commission, the Staff, and the many parties with a legitimate interest in the workings of the Plan would be unable to make an informed assessment.

According to Staff, the individual reporting requirements are also meaningful in a regulatory sense. It is necessary that AI be required to report on service quality, (item (13 above), in light of its recent, well-publicized and admitted failures in this regard. Likewise, Ameritech should be required to report on infrastructure investment, given its own commitment in the merger proceeding to continue to invest in its infrastructure. (See, Merger Order 98-0555). Similarly, Staff claims that the Commission's authority to rescind alternative regulation plans that fail to satisfy the statutory requirements for such plans, means that AI should be required to produce basic financial information, especially where, as is the case with respect to items (1)-(6) above, the information is not available from other sources. While Staff recognizes that Ameritech already files information responsive to items (8)-(11), (13) and (14) above, it would have there be a one single source of information regarding Ameritech's performance under the plan, which the price cap filings do not provide.

AG's Position

The AG basically agrees with Staff's position that the reporting information provided each year in the annual rate filing continues to be necessary to enable the Commission to monitor that the plan is being properly applied and that the intended benefits are realized. Also, the GCI/City maintain that without a clear directive from the Commission to provide certain types of information, the Commission and interested parties will be unable to obtain it when needed in the future.

Commission Analysis and Conclusion

While the question of reporting arises in our historical assessment, it is a forward-looking issue which we defer to a later section of this Order.

(d) The extent to which Illinois Bell has modernized its network and additional modernization plans for the near term.

AI's Position

AI witness Gebhardt's testimony indicates that substantial investments were made in deploying additional fiber facilities through the network. (Am. Ill. Ex. 1.1) He explains that fiber facilities improve efficiency and reliability in the transport of voice and data. And they are an essential building block for providing advanced series of the future. Further, Mr. Gebhardt notes that AI has completed its deployment of SS7 capability, a technology which improves network efficiency and call handling processes, and provides capabilities for the Ameritech Inteiligent Network platform. In addition, Mr. Gebhardt testified, the Company expended many millions to modify its network and open it to completion.

A summary of Ameritech Illinois' investments over the 1994-99 period was put into record (Am. Ill. Ex. 1.1, Schedule 3). as were its modernization plans for the future. (See, Jacobs testimony, Am. Ill. Ex. 5.0).

Staff/sPosition

Staff avers that AI's network modernization reports must be submitted in sufficient detail to allow the Commission to determine (a) whether and how each investment was made, (b) whether it serves to maintain the quality of Ameritech's network, and (c) whether the investment is in the interest of all of Ameritech's customer classes. According to Staff, these reports are audited by an independent third party selected by the Commission and must be expressly approved by the Commission. With these measures in place, Staff maintains that the Commission need not address anything other than the reporting and monitoring aspect of the matter in this docket.

AG's Position

According to the AG, there were insufficient network access lines available for installation in the latter half of year 2000, resulting in extensive delays in the installation of "Plain Old Telephone Service" or POTS. During this time, the AG notes, consumers waited weeks and even months for installation of a simple telephone line or repair in some areas of the state, the number of out of service complaints increased, and AI failed to return an increasingly greater number of customers to service within the 24 hour benchmark.

Despite AI's reported $3.7 billion infrastructure investment, the AG notes that there has been service quality degradation. According to the AG, AI's inadequate network invested has affected DSL expansion; has been one of the primary reasons for the Company's inability to comply with the Commission's installation requirements; and also served to undermine the Company's ability to provide advanced Internet services. It was SBC's chairman, the AG claims, who publicly attributed AI's service quality problems to inadequate investment in infrastructure. (GCI Ex. 11.0 at 68-69.) Similarly, GCI witness Charlotte TerKeurst determined that investment in network access facilities has been inadequate to keep up with demand.

Ms. TerKeurst noted that almost $1 billion of AI's $3 billion commitment was spent on just one of AI's high margin services, Project Pronto, which extends loop reach for current and future broadband services offered by an Ameritech affiliate. All of this, the AG claims, compels the conclusion that the Plan incentives did not lead to an adequate portion of the $3.7 billion investment being directed to basic infrastructure. And, regardless of how much AI spent on opening its networks, the AG claims that its investment was ineffective in facilitating meaningful competition.

In view of AI's service quality problems, the AG maintains that the Commission should not lessen the reporting requirements on infrastructure investment. And, the increased reporting detail required by Merger Order should also be a part of the Company's annual rate filings. According to the AG, the annual infrastructure investment reports that were ordered in the Merger docket should be relied on in determining whether the existing infrastructure investment should be increased to keep any alternative regulation plan in compliance with statutory requirements.

Commission Analysis and Conclusion

No party denies that AI spent the amounts to which it committed. AI has put into the record the necessary evidence and Staff informs us of the detail in reporting on its investments to which AI is subject.

(e) A listing of all services in each basket and a report of the cumulative percentage changes in prices for each service during the period the price cap mechanism has been in effect.

AI's Position

Ameritech Illinois maintains that it supplied the required list of services and the report of cumulative percentage price changes for those services. (Am. Ill. Ex. 1.0, Schedule 6). According to AI, the data demonstrate that a wide range of noncompetitive services experienced significant rate decreases over the first five-year term of the Plan. AI explains that Price reductions, in general, were targeted at services where contribution levels were relatively high and where price reductions would encourage broader deployment of the Company's services. Also, the Company attempted to avoid reductions for those services, for example the residential network access line, where the price-to-cost relationship is too low today.

Staff's Position

After reviewing AI's response to this requirement, Staff is of the opinion that Ameritech's characterizations concerning actual price changes are accurate. Staff, however, does not support AI's estimate of the cumulative revenue reductions resulting from these rate reductions where Ameritech asserts that the Plan has resulted in total benefits to consumers on the order of $943 million.

According to Staff, Ameritech's revenue reduction calculations do not take into account increases in demand for services that resulted from rate reductions. Staff states that the impact of the demand stimulation is an increase in revenue and, therefore, Staff believes that the figures overstate what the benefit to consumers under the Plan. As support for its argument, Staff points to Ameritech's own admission that it targeted rate reductions to those services for which demand would increase because of such rate reductions (i.e. for price elastic services). Where Ameritech believes that rate reductions would result in increased demand, its calculation of cumulative revenue reductions should reflect this increased demand.

Further, Staff notes, Ameritech continued to include revenue reductions for services declared "competitive" in its calculation of consumer benefits. Staff views AI's calculation is as follows: multiplying the mandated rate reductions in the first year ($30 million) by five, then adding that figure to the mandated rate reductions in the second year (after it has been multiplied by four); adding that cumulative total to mandated rate reductions in the third year (after it has been multiplied by three), and so on. (Tr. 396). In other words, Ameritech continued to count as consumer "benefits" the reductions in rates that did not in fact occur, or at best, occurred outside of the Plan.

According to Staff, almost all business services were subject to the Plan at its inception, and almost none are subject to it now. Revenues in the business basket subject to the Plan have actually declined from $409 million in 1996 to $18 million today. Yet it appears to Staff that Ameritech continues to count rate reductions for that $391 million worth of reclassified services as "benefits" of the Plan. In Staff's view, Ameritech cannot justly claim that customers benefit from service reclassification. Although Staff was unable to provide a sufficient proxy for the actual savings received by customers, it maintains that Ameritech's estimated benefit to consumers is significantly inflated.

AG's Position

According to the AG, the AI list shows that in all the years of the Plan's operation, it has made no reductions to the residential network access line ("NAL") charge, which is the most basic and inelastic element of local exchange service. Indeed, the AG argues, the network access line charge is a prerequisite to receiving any other landline telecommunications service, (including long distance) and is paid by customers every month, regardless of whether or not they make calls on the network.

The AG claims that by giving AI the flexibility to decide how rate reductions would be allocated among various services, the Plan allowed the Company to ensure that the most inelastic portion of the local phone bill never decreased while most of the benefits of alternative regulation went to high-volume customers. Not only is this pricing structure inequitable, the AG maintain, but it runs counter to the Commission's policy to guard against "Ramsey pricing." (See Alt. Reg. Order at 70).

During the plan, the AG argues, AI made only modest reductions to those services in the residential basket most often used by residential customers: the Company reduced usage rates for band A, (where customers place the most local calls), by only 3.85%; less-frequently placed band B calls enjoyed a higher discount of between 21 and 33%; and the major reductions, ranging from 42% to 297%, resulted from increasing the residential volume discount, which is based on total usage. Hence, the AG asserts, AI linked rate reductions to increased use of its system, which drastically limited rate reductions to low or moderate use customers.

The AG notes that the Plan included certain pricing constraints such as limiting pricing flexibility to 2% of the API and requiring rate reductions for each of four service baskets in an effort to insure that all classes of customers benefited from the anticipated rate reductions. (Alt. Reg. Order at 69-70). AI's failure to reduce the NAL rate and Band A usage and its use of volume discounts to implement rate reductions under the Plan, the AG claims, show that the plan failed to benefit all classes of customers and requires that the plan be modified going forward.

Commission Analysis and Conclusion

There are issues raised here which will be discussed further in this Order.

(f) A listing of any services which have been withdrawn during the period.

AI's Position

To satisfy its requirement, Ameritech Illinois provided a list of all services which were grandfathered or withdrawn during the first five-year period of the Plan. (Am. Ill. Ex. 1.0, Schedule 2). In general, the Company sought to grandfather and/or eliminate services where demand was low, continued product support costs were high and/or technological advances created a better substitute service. For example, Basic 911 Type I service was grandfathered in 1996 as better, more reliable 911 service became available. At the time the service was grandfathered, only two customers subscribed. There is currently no demand for this service.

Staff's Position

Staff considers the list AI provided to be complete, unobjectionable, and as such raises no issues for this proceeding.

AG's Position

According to the AG, the list which AI provided did not specify which were services, which were payment options, or which applied to the residential, business, carrier or other service category. As such, the AG claims, the listing does not help the Commission discern the significance of the discontinuation of these services.

Commission Analysis and Conclusion

Based on the foregoing discussion, we find no issue raised for this proceeding.

(g) A listing of all services which have been reclassified as competitive or noncompetitive during the period.

AI's Position

As required, Ameritech Illinois provided a list of all noncompetitive services which were reclassified as competitive over the first five-year period of the Plan. (Am. Ill. Ex. 1.0, Schedule 3). According to AI, a significant number of services -- particularly business services -- are now available from multiple providers in Ameritech Illinois' service territory. This result, AI maintains, is consistent with both the statutory construct, because alternative regulation plans only apply to noncompetitive services, and with the policy underpinnings of price regulation, which is intended to determine prices where market forces do not exist.

Staff's Position

Ameritech has produced the required list which Staff considers to be accurate to the extent that it correctly describes which services have been reclassified. But, Staff argues, the list does not provide any insight as to the impact on the Plan resulting from reclassifying a service as competitive. It is Staff's opinion that Ameritech's reclassification of services have significantly weakened the Plan. Staff discussion on the impact of competitive reclassification appears in a subsequent section of this Order.

AG's Position

The AG observes that while AI witness Gebhardt's direct testimony provides the Commission with a list of services which AI reclassified as competitive since the inception of the plan, he did not further explain that many of those reclassification have not withstood Commission scrutiny. For its part, the AG notes that some of these reclassifications, (including business usage for band B and C calls and operator assisted and calling card usage and usage originating in MSAs 1,2,3,6,7,9 and 15), were reversed by a Commission order in October 1995, that was later affirmed by the court. See, Illinois Bell Telephone Co. v. Illinois Commerce Commission, 282 Ill.App.3d 672 (3d Dist 1996). While AI also lists a 1998 reclassification for all business services in Illinois and for residential service in 19 exchanges as competitive, the AG notes that a Commission-initiated investigation into the propriety of those reclassifications, i.e., Docket 98-0860, is pending.

The AG asserts that the result of reclassifying a service as competitive is that it removes the service from the alternative regulation plan. Thus, services classified as competitive are no longer subject to the pricing constraints of the plan, nor are revenues from the services included in the calculation of the service quality adjustment. According to the AG, the reclassifications pursued by AI during the plan, removed about 35% of its revenues from the Plan, and left it significantly less effective in both retaining the benefits of productivity for consumers and protecting consumers from market abuse. In the AG's view, the plan needs revisions to eliminate the incentives to prematurely reclassify services as competitive and raise rates unconstrained by competition or the price cap index.

As part of alternative regulation, the GCI/City propose that the Commission require the Company to maintain appropriate records to enable the Commission and the parties to review the relevant data to assess the effect of reclassifications on rates and on the operation of the Plan. The report should include the data Staff requested, but was unable to obtain from the Company during this review proceeding, i.e., the revenue received from rate increases to reclassified services plus unrealized savings that would have occurred had the services remained under the price cap mechanism. Other important information is whether the reclassification was subject to Commission review and ultimately changed.

Commission Analysis and Conclusion

The Commission finds that AI complied with the instant requirement in letter if not in spirit. An issue has been raised with respect to reclassification which will be explored further in other sections of this Order.

(h) A summary of new services which have been introduced during the period.

AI's Position

Ameritech Illinois provided a list of the new services which it introduced during the first five-year period of the Plan. (Am Ill. Ex. 1.0, Schedule 4). It claims that new services were an important source of revenue for the Company and are producing about $200 million in annual revenues.

Staff's Position

Staff does not dispute the completeness of the list Ameritech has provided. It is of the opinion, however, that a number of the services described by Ameritech as "new" are not so in reality. In Staff's view, the great majority of the revenue Ameritech has realized from new services (apparently over 90%) is derived from so-called "optional calling plans," which are little more than repackaging of Band A, B, and C residential services at differing rates. The significance of this repackaging, according to Staff, is that it provides the rationale for Ameritech to place these optional calling plans in the "Other Services" Basket, rather than the "Residence" Basket.

These services, Staff claims, are all basic residential services, which the vast majority of customers need and use regularly. To classify them as "other" rather than "residential" makes little sense, and benefits no one but Ameritech. In authorizing the current Plan, Staff asserts, the Commission surely expected some degree of innovation in product, not simply in the novelty of marketing of same.

Staff considers improper classification of this sort to be a problem because shifting what is clearly basic residential service revenue to the "Other Services" basket, compromises the ability of the price cap plan to provide reductions in rates for residential services. The current four-basket system was established to limit the likelihood of discrimination against residential customers. As more revenue is transferred out of the Residence Basket to the Other Services Basket, Staff contends, more rate reductions will also shift to the Other Services Basket. Since there have been no reductions for local call plans in any of the annual filings under the Plan, Staff believes it fair to conclude that non-essential services are receiving rate reductions that otherwise would have been earmarked for basic residential services. To remedy this unfair situation, Staff recommends that local calling plans be moved out from the Other Services Basket to the Residential Basket.

AG's Position

According to the AG, the AI list of new services lacks sufficient detail for the Commission to draw any conclusions about the nature of the new services or whether the plan has led to more new services than would have been offered in the absence of alternative regulation. The listing fails to provide a description of the services or to indicate whether the new services fall in the business, carrier, residential or other category.

Some of the "new services" such as the 1995 usage discount plans, the 1996 ValueLink offering, the 1997 residence local call plans, and the 1999 Anytime rate calling plan, the AG contends, merely represent different billing options for existing services. The AG notes GCI witness TerKeurst's explanation that a bundle of services that are already available to customers on a stand-alone basis "is properly labeled as a restructured service because it modifies the method of provisioning and charging for the same services previously available." (GCI Ex. 11.0 at 61). Such "restructured" services, the AG maintains, do not represent innovation or an expansion of service options.

The GCI/City further note that in "repackaging" local usage, AI increased the rates for Band A, and increased the average rate for Band B calling in its Simplifive and CallPack programs. (See Order at 31-32; Docket 00-0043 (Jan. 23, 2001). The only calling plan rate lower than the regularly tariffed rate was for Band C usage. Band C tariffed usage rates were increased from 4 to 10 cents per minute after their competitive reclassification, compared to the calling plan rates of 5 cents per minute and 10 cents per call. These "new services" were really rate increases for all but a subset of consumers with a particular calling pattern. (Id. at 33) Further, GCI/City agree with Staff's view that AI showed innovations in marketing and not in product.

While AI refers to one service -- Privacy Manager -- to show its "innovation" and refers to "a large number of promotional offerings" and optional calling plans, AI witness Gebhardt did not describe any of its promotional offerings. More importantly, GCI / City claim, Mr. Gebhardt admitted that AI's innovations under the Plan were in the area of pricing, "not new services, per se."

Commission Analysis and Conclusion

AI provided the list required. The Commission notes that it will examine the issues raised herein in another section of this Order.

(i) Information regarding any changes in universal service levels in Illinois Bell's service territory during the price cap period.

AI's Position

Ameritech Illinois provided information regarding service levels during the period that the Plan was in effect. Based on data from FCC reports, telephone subscribership ranged between 93.6% and 93.8% for the State of Illinois for the four-year period immediately prior to implementation of the price cap plan. For the five years of the Plan's operation, the comparable data ranged between 91.8% and 93.6%. Accordingly, to AI, data is not available for Ameritech Illinois' service territory specifically. (Am. Ill. Ex. 1.1, pp. 62-63).

Although the data suggest a decline in universal service over the last five years, AI maintains that there is no evidence that this problem is related to the Plan in any way. If anything, AI claims, the Plan has resulted in price reductions, which logically would have had a positive impact on subscribership. Furthermore, AI maintains that its rates generally are low relative to those of incumbent LECs in other states. In light of these considerations, AI contends there must surely be something other than price that is driving the results.

AI states that study has been commissioned by Ameritech Illinois, the ITA and UTAC with the involvement of Commission Staff, to determine what is causing these results. This study should be available in the relatively near future. If the Commission were to ultimately conclude that there is a subscribership issue in Illinois, a separate proceeding could be established to determine what the problem is and evaluate the possible solutions.

Staff's Position

According to Staff, Ameritech has provided the requested information on this issue. (Ameritech Ex. 1.1 at 68-69).

Staff informs that telephone subscribership (percentage of households with telephones) declined in Illinois between 1995 and 1999, while it has increased nationwide. Even though subscribership increased in 2000, Illinois' levels are still less than the national average. This problem, however, cannot be attributed conclusively to the Plan in Staff's opinion, inasmuch as other Illinois incumbent local exchange carriers ("ILECs") have lower subscribership levels in their service territories than Ameritech has in its territory. Moreover, the Commission, the Staff, and incumbent carriers, including Ameritech, have joined together to study the causes of low subscribership in Illinois, and address them to the extent possible. Staff, therefore, is of the opinion that Ameritech is in compliance with this requirement and that this is not an issue for this proceeding.

AG's Position

The AG notes that AI only provided the FCC data on Illinois telephone subscribership. This document, the AG states, shows a decline in telephone penetration during the course of the plan from 93.6% in 1994 and 1995 to 92.2% in 1997. In his testimony, AI witness Gebhardt admitted that Illinois' standing in comparison to the rest of the nation appears to be low, whether one looks at current or historic data.

According to the AG, GCI witness Dunkel provided more specific universal service information, showing that in 1999, (the last year for which annual information is available), Illinois reached a low point of 91.8% telephone penetration. Mr. Dunkel demonstrated that telephone penetration rates in Illinois have declined during the course of the Plan, and that the FCC singled out Illinois as the only state with a "significant decrease" in penetration from 1983 to July, 2000. Mr. Dunkel also indicated that Illinois is 2.4% below the national penetration rate, whereas in 1995 it was only .3% away from the national average.

The AG maintains that AI provides 85% of the access lines in Illinois and accordingly the Illinois penetration rate shown in FCC data could reasonably be linked to AI's penetration rate. The 1.8% decline from 1995 to 1999 substantially exceeds the 1.4% change Mr. Gebhardt admitted was statistically significant, the AG argues, and should be a matter of concern to the Commission in this evaluation of alternative regulation

Whereas AI offers no definitive explanation for the decline in penetration rates the GCI/City suggest that the repackaging of non-competitive local usage in calling plans at higher local rates, the aggressive sales techniques for optional, vertical features, and poor quality of service, are easily understood reasons for both the disconnection for lack of payment, and consumers' avoidance of AI's system altogether.

Commission Analysis and Conclusions

While universal service is a matter of great concern to the Commission, we see no evidence that the Plan is directly implicated in the low level of subscribership. We find that the conclusions that GCI/City suggest are not sustainable without an extensive and comprehensive analysis. To this end, as both AI and Staff inform us, there is a study underway to ascertain the real cause of this problem and we will proceed further on that basis. This is not the proper proceeding to delve into an issue of this nature and magnitude.

(j) Whether, and the extent to which, the adopted regulatory framework has met each of the established statutory and regulatory goals?

Commission Analysis and Conclusions

At this juncture the Commission's focus in this Order will now be centered on the particular statutory goals and expectations under which we authorized the inception of the current Plan. Our analysis here maintains a historical perspective as we assess how the Plan has functioned over the initial term and begin to explore the type and extent of modifications needed in going forward.

III. THE STATUTORY CRITERIA AND GOALS

When approving Ameritech Illinois' Alternative Regulation Plan in 1994, the Commission had to make seven affirmative findings under Section 13-506.1(b) and "consider" six additional policy goals set out in Sections 13-506.1(a) and others listed under 13-103 of the Act. With respect to these latter policy goals, the Commission concluded that, although an overall assessment as to whether the Plan "constitutes a more appropriate form of regulation" is required, it was not necessary to make an affirmative finding on each and every one. (Alt Reg Order at 180). In determining that the Plan met these regulatory criteria in 1994, the Commission expressed expectations as to how they would be met. (Alt Reg Order at 179-192). Here we will proceed to examine the Plan's performance in the context of those expectations and statutory demands.

In this section, we observe that a number of the provisions to be examined either overlap or are otherwise related and, hence, it is appropriate in these instances that they be considered jointly.

1. Has the Plan Produced Fair, Just, and Reasonable Rates

Authority: Sections 13-103; 13-506.1(a); 13-506.1(b) and the Alt Reg Order.

In 1994, noting that Ameritech Illinois' last general rate case had been in 1989, the Commission conducted a traditional earnings analysis to establish an appropriate starting point for noncompetitive service rates under the Plan; and adopted a price index to ensure that those rates remained fair, just and reasonable over time. The Commission found that this index would continue to produce reasonable rates because it appropriately reflected the impact of economy-wide cost changes which should be flowed through to consumers, less an appropriate productivity offset. The Commission further found that, by linking price changes to cost changes in the economy (rather than to the Company's own internal costs), the Plan would "protect ratepayers from the impact of competition and management error." The Commission also noted that, given the magnitude of the productivity offset which had been selected, both the "real" and actual prices of noncompetitive services were likely to decline. (Alt Reg Order at 186).

AI's Position

AI maintains that noncompetitive service rates performed precisely as the Commission expected. The price index included appropriate measures for both inflation (GDPPI) and the productivity offset, which flowed through to consumers <u>all</u> of the productivity gains achieved by the Company during the 1995-99 period. As the Commission had predicted, AI maintains, the real and actual prices of noncompetitive services fell significantly over the 1995-1999 period.

In this proceeding, Ameritech Illinois provided external benchmark comparisons to further support the reasonableness of its noncompetitive service rates, referencing the standard of "affordability," which is set out in Section 13-103(a) of the Act. By comparing rate changes under the Plan to both the CPI and changes in wage levels over the 1994-99 period, the Company claims to have demonstrated that its noncompetitive rates are significantly more affordable today than they were in 1994. AI maintains that its rates are also lower than those of other telephone companies, both in Illinois and nationwide, and are comparable to those of its Illinois competitors.

The Company asserts that the GCI position, that fair, just and reasonable rates must equate to what would result from a traditional rate case, is inconsistent with the economic and policy underpinnings of price regulation, not supported by the Alt Reg Order and would give Section 13-506.1 a wholly nonsensical interpretation .

According to AI, the meaning of the term "fair, just, and reasonable" under Section 13-506.1 must be considered within the context of the overall purpose of the statute and the Commission's 1994 Order. AI asserts that Section 13-506.1 of the Act clearly empowers the Commission to substitute alternative forms of regulation for rate of return regulation in toto:

> Notwithstanding any of the ratemaking provisions of the Article or Article IX that are deemed to require rate of return regulation, the Commission may implement alternative forms of regulation in order to establish just and reasonable rates for noncompetitive telecommunications services including, but not limited to, price regulation, earnings sharing, rate moratoria, or a network modernization plan. Section 13-506.1(a). (Emphasis added).

A plain reading of the statute, AI claims, shows that "just and reasonable" rates are based on and measured against something other than traditional rate of return principles. To assert otherwise, AI claims, is to devise a circular proposition: i.e., the Commission can approve alternative forms of regulation, but only if they produce precisely the same rates as a traditional rate case. Interpreting the statute this way, AI claims, would be nonsensical and outside the accepted canons of statutory construction.

AI asserts that the incentive mechanisms which lie at the heart of price regulation -- and which deliver benefits to consumers in the form of improved efficiency, investment in the network, and innovation in services -- are based on the premise that there is no ceiling on earnings. Indeed, by subjecting itself to price regulation, AI maintains, it "assumed the risk" of earning less than a reasonable return on equity and rate base, in exchange for the "opportunity" to earn in excess of what would typically be authorized in a rate of return environment. This was the understanding in 1994. (See, Alt Reg Order at 7-12, 181-82.). Further, AI points to Staff witness Dr. Staranczak's testimony as additional support:

> "Under alternative regulation subscribers receive a guarantee that their overall rates will rise less than general inflation while Ameritech Illinois gets the opportunity to earn higher returns. If Ameritech does indeed earn higher returns under alternative regulation this should not be interpreted as a failure of the Plan but recognized as one of the possible outcomes that was anticipated." (Staff Ex. 2.0, pp. 4-5).

In response to persistent questioning by GCI attorneys, AI argues, Dr. Staranczak testified unequivocally that earnings are irrelevant in determining whether the Plan functioned properly. (Tr. 1249-54, 1266-67, 1281-82, 1284).

The assertion that high earnings might raise a "warning flag" that the terms of the Plan may have been too favorable to the utility, must also fail, according to AI. Such "warning flags" it contends, do not translate into rate cases unless the record demonstrates that the price index seriously malfunctioned. AI contends that is not the situation here where the price index was set properly, AI implemented the required rate changes, and there is no evidence shows the resulting noncompetitive service rates to be unreasonable. Simply because the Commission required the Company to report earnings data to provide an "early warning" that the index was misspecified says nothing about reinitializing rates AI claims, particularly where as here, the index worked properly. And, the Commission's expression of a willingness to reconsider earnings sharing also says nothing about reinitializing rates as even earnings sharing plans assume that earnings will exceed what would result from a conventional rate case.

Further, the contention that an earnings analysis must be performed for Ameritech Illinois' total intrastate operations is incorrect, as a matter of law, according to the Company since both Section 13-506.1 and the Commission's 1994 Order clearly limit the Plan to noncompetitive services. Contrary to GCI witness TerKeurst's assertions, neither Section 13-506.1(a) (which authorizes the Commission to adopt earnings sharing), nor the "public interest" standard in subsection (b)(1) extend the application of the statute to competitive services. Similarly, the Commission's 1994 Order expressly excludes competitive services from the operation of the Plan:

> Price regulation directly ensures that noncompetitive rates will remain just and reasonable, while market forces will control competitive service prices and earnings. (Alt Reg Order at 187.)

There are, AI recognizes, substantial disputes between it and the GCI/City relative to competitive service rates, competitive service reclassifications and the pricing actions which the Company has taken over the last five years relative to those services. AI contends, however, that competitive service prices are not within the scope of this proceeding, which was initiated to assess the functioning of the <u>Plan</u>. According to AI, the Plan cannot reasonably be indicted based on service rates and earnings to which it was not subject in the first place. The outstanding issues associated with service reclassifications, AI contends, should be and will be, resolved in other proceedings, such as Docket 98-0860 (competitive classification of certain business services).

Thus, AI argues, even if the Commission were to use an earnings analysis to evaluate whether Ameritech Illinois' rates are just and reasonable -- which it should not –such an analysis would have to be limited to noncompetitive services. AI asserts to have demonstrated that its 1999 earnings on noncompetitive services were only 5.55%, well below Ameritech Illinois' weighted cost of capital under either Staff's analysis or the Company's. According to AI, no party either disputed the mechanics of this allocation methodology or demonstrated that the results were in any way unreasonable. Indeed, AI notes Staff witness Hoagg's testimony wherein he stated that he that he would only be concerned if Ameritech Illinois' noncompetitive services were generating extremely high earnings, over an extended period of time, and, even then, only if further investigation revealed that these earnings were inconsistent with the policy underpinnings of price regulation. (Tr. 1223-26). None of these factors apply here, says AI.

To the extent that GCI witness Dr. Selwyn and Staff witness Marshall reject the Company's noncompetitive service earnings analysis, on grounds that jointly used plant and common costs cannot be meaningfully allocated between competitive and noncompetitive services, AI claims they are wrong. According to AI, jointly used plant and common costs have been separated between the state and interstate jurisdictions for ratemaking purposes for decades through the separations process. Regulated costs are routinely separated from unregulated costs to comply with the FCC's Part 64 requirements and Part 711 of this Commission's rules. Common costs are routinely allocated between competitive and noncompetitive services under the Aggregate Revenue Test to comply with Section 13-507 of the Act for ratemaking purposes. (See, Illinois Bell Telephone Company v. Illinois Commerce Commission, 203 Ill. App. 3d 424, 561 N.E.2d 426 (2nd Dist. 1990); See also, Order Docket 89-0033 (Remand), adopted November 4, 1991, at 200-203). In fact, AI notes that professional economists testifying in the 1994 proceeding, including Dr. Selwyn himself, proposed allocation methodologies to separate competitive and noncompetitive service earnings. (Am Ill. Ex. 1.3, pp. 24-25). The Company claims that its analysis is based on essentially the same approach as the Aggregate Revenue Test and provides a valid basis for determining noncompetitive service earnings.

So too, AI maintains, the GCI contentions that the Company's earnings demonstrate that the Plan was "mis-specified" are not supported by the record. To the contrary, AI maintains, Dr. Meitzen's analysis showed that the X factor was too high over this period. As such, AI asserts, this means that noncompetitive service customers received more benefits than they were entitled to, not fewer.

The City claims that the Company's earnings cannot be explained by improved productivity are proved wrong by the record, AI contends. To be sure, Ameritech Illinois' total factor productivity growth rate increased from 2.2% over the 1984-91 period to 4.2% over the 1992-99 time period. Thus, AI notes, it almost doubled. Furthermore, this data represents growth in TFP; that is, even if it had remained at the 2.2% level, the Company would still be increasing its productivity year-over-year by 2.2%. The fact that the 3.3% overall X factor did not change -- which the City of Chicago relies on for its statement -- is a function of the fact that the Commission overstated the Company's future input price performance in 1994 and the parties' unanimous proposal to shift to an industry-wide TFP figure. It does not, AI asserts, represent stagnant productivity performance.

AI would dismiss as untrue the CUB and the AG contentions that it would not have achieved these earnings in a competitive industry. AI witness Dr. Avera explained, that this was a period of record economic growth and record corporate profits. (Am. Ill. Ex. 8.0, pp. 8-10). The evidence shows that companies in fully competitive industries reported earnings of which, in CUB's words, Ameritech Illinois "can only dream". For example, AI notes that in 1999, Quaker Oats, General Mills and Campbell Soup outstripped Ameritech Illinois' return on equity by over 13 thousand, 20 thousand and 25 thousand basis points, respectively. (Am. Ill. Ex. 1.4, p. 28). It is a fiction, AI contends, that the "reasonable return" produced by conventional rate case analysis bears any necessary relationship to what actually transpires in competitive markets. It is a necessary fiction in the world of rate of return regulation, but it should not be confused with reality.

AI notes that both CUB and the Attorney General rely on Ms. TerKeurst's comparison between the earnings of the major BOCs over the 1990-99 period, - based on ARMIS reports to the FCC - in order to argue that Ameritech Illinois' profitability greatly exceeded that of its peers. AI disputes the validity of this comparison. The record shows, AI contends, that it treated certain industry-wide accounting changes (i.e., FAS 106, FAS 112 and FAS 71) differently for ARMIS reporting purposes than did the rest of the industry. As a result of this anomalous accounting treatment, Ameritech Illinois' total stockholder equity had dropped by 50% by 1994-95, which, in turn, artificially inflated its "earnings" relative to the other BOCs. AI points out that Ms. TerKeurst herself agreed that no meaningful comparison can be made between companies' earnings unless the underlying data is stated on a consistent basis. (Tr. 2174-75).

The reasonableness of Ameritech Illinois' competitive service rates is beyond the scope of this proceeding, which is directed at the performance of the Plan over its initial term. The Plan, both by its terms and by statute, is limited to noncompetitive services and the GCI's statutory citations are unavailing. Section 13-506.1(b)(4) reference to Section 13-103(a) does not expand the scope of this section i.e. all of Section 13-506.1 follows the prefatory language which authorizes the Commission to implement "alternative forms of regulation" in order to establish just and reasonable rates for "noncompetitive telecommunications services." (220 ILCS 13/506.1).

Ameritech Illinois does not dispute the fact that other provisions of the Public Utilities Act provide the Commission with "just and reasonable" authority over competitive service rates i.e., Sections 9-250 and 13-505(b). Nothing in the Commission's 1994 Order, however, even remotely suggests that competitive service rates were to be the subject of this proceeding.

For services properly classified as competitive, AI maintains, the issue of "just and reasonable" rates is far more complex than the earnings review on which GCI is relying. To be sure, AI contends, any regulatory restrictions on competitive service pricing should apply even-handedly to all providers of that service. This has been the Commission's practice to date and IXCs and CLECs have routinely been exempted from rate of return regulation in their certificate application proceedings. Thus, before embarking on any analysis of Ameritech Illinois' competitive service rates, AI maintains, the parties would have to address what standard other than earnings would be used to determine "just and reasonable" rates. And, in order to establish industry-wide pricing rules, IXCs and CLECs would have to be provided notice and an opportunity to participate. No such notice, AI claims, was issued in connection with this proceeding.

Finally, AI asserts, even if competitive service rates were at issue in this proceeding -- which they are not -- there is no evidence that they warrant a $1 billion rate decrease. As CUB acknowledges, only "some" of them have been the subject of rate increases. (CUB Init. Br., at 34). Ameritech Illinois believes that these rate changes were appropriate in the marketplace and as to the remaining services whose rates have not changed, there is absolutely no evidence that their rates are too high. The mere fact that Ameritech Illinois' competitive services generate higher earnings than noncompetitive services reflects long-established pricing policies and says nothing about their reasonableness: they are competitive largely because they are profitable and profit margins attract competitors. Given the poor returns generated by noncompetitive services (5.55%), Ameritech Illinois' financial viability has depended on and continues to depend on the fact that competitive services in aggregate earn substantially above its authorized return.

Staff's Position

Staff maintains that the most significant regulatory and statutory goal which an alternative regulation plan must meet is to guarantee just, reasonable and affordable rates for non-competitive services. According to Staff, alternative regulation plans serve this desired end by regulating the price of those services as opposed to regulating a company's earnings.

Staff asserts that Ameritech Illinois' noncompetitive rates today are just and reasonable. Its supporting analysis is quite simple:

> "If rates were set at a just, reasonable and affordable level in 1994, and thereafter declined, notwithstanding modest levels of inflation, it stands to reason that such rates are now a fortiori just, reasonable and affordable." (Staff Init. Brief at 30).

Staff takes issue with the GCI's recommendation that rates be reinitialized in this proceeding based on Ameritech's earnings. The arguments advanced in support of reinitialization are unconvincing, Staff asserts, because they do not focus on rates, but rather upon AI's rate of return or other matters extraneous to the Plan itself, such as reclassification. Such arguments, Staff contends, betray either a failure to understand, or to accept, the concepts behind performance-based regulation, which focuses primarily on the regulated company's price performance, rather than on its earnings.

The essence of the GCI/City's error, in Staff's view, is that they simply refuse to grapple with this principle.

Staff notes that the Commission should not assume, however, that it is in complete, or even substantial, agreement with the Company. While Ameritech might suggest that the incentive mechanisms which underlie the fundamental superiority of alternative regulation vis-à-vis rate of return ("ROR") derive from, and depend on, an absolute absence of a ceiling on earnings under alternative regulation, Staff clearly disagrees. This type of "sky is the limit" view on earnings, Staff maintains, is simply unsupportable.

Staff believes it has well-demonstrated that the proper standard to be applied under alternative regulation is not the imposition of rate levels associated with rate of return regulation, but rather an evaluation of whether the Plan produces affordable, just, and reasonable rates – a price performance analysis. To the extent that AI would contend that an earnings analysis has no place in an alternative regulation environment, i.e., that any level of earnings produced by a plan are acceptable, and that any rates produced by a plan are, by definition, just and reasonable, it is wrong.

According to Staff, the statutory fair, just and reasonable rate standard places upper and lower limits on acceptable rate levels under an alternative regulation plan, and earnings levels associated with those rates. For a variety of reasons, the "zone of reasonableness" of rates is broader and more elastic under alternative regulation than under rate of return regulation. This is an inherent part of the alternative regulation "compact" and reflects such realities as increased competitive entry, generally increased risk for the regulated firm, and the potential for increased benefits for all stakeholders, notably consumers. Nevertheless, Staff asserts, the zone of just and reasonable rates under alternative regulation is far from being unlimited.

It is bounded on the lower end, Staff explains, by considerations of financial integrity of the regulated company, and its attendant ability to deliver appropriate levels of service availability and quality. To illustrate this concept, Staff assumes that Ameritech's financial condition had deteriorated during the Plan to a degree that threatened its ability to provide adequate service to consumers. There can be no doubt, Staff contends, that in this situation, the Commission's statutory responsibilities would require it to intercede by adjusting prices and/or key plan parameters to forestall or ameliorate significant adverse consequences.

The zone of reasonableness, Staff asserts, is bounded on the upper end by earnings levels that clearly exceed those that could be explained by enhanced cost effectiveness, and technical and market progressiveness of the regulated company. Beyond this bound are earnings levels associated, at least in part, with such things as significant misspecification of Plan parameters, misapplication of the Plan, or behavior that successfully defeats the overall effectiveness of an alternative regulation plan.

These bounds and the fair, just and reasonable standard under alternative regulation are not readily susceptible to prior or precise quantification Staff contends. To achieve the desired end, requires informed regulatory judgement and analyses. This does not, however, diminish the importance of these bounds, or call into question their existence. Since prices alone do not provide directly the required information, earnings appropriately and necessarily are used as a proxy indicator. This is the major role of earnings analyses in any review of an alternative regulation plan. Having applied its judgment, Staff concludes in this proceeding that Ameritech's rates and related earnings are not outside the zone of reasonableness, either on the low or high side, and notes the absence of persuasive evidence to the contrary. It must be recognized however, Staff claims, that prices and associated earnings outside this zone <u>might</u> <u>have</u> occurred, and there was no assurance in 1994 against such a result. Similarly, it is conceivable that this might still occur in the future under an extension of the alternative regulation plan, despite the expectations or intentions of the Commission, Ameritech or other parties.

For this reason, Staff recommends that an extension of the plan should provide for a review comparable to this proceeding, to be concluded no later than five years from the date of extension of the Plan. An analysis of Ameritech's earnings, as well as its price performance, Staff maintains, should also be an integral component of that review.

GCI/City's Position

CUB claims that the rates currently being charged under the Plan are *not* just and reasonable based on the analysis that GCI/City witness Smith performed of the Company's pro forma income statement and the hundreds of data requests he reviewed in order to assess the earnings of AI under the price cap plan and to propose adjustments. His work, CUB contends, showed an AI intrastate return on equity of a staggering 43.08% -- nearly four times the authorized return on equity established by the Commission in the Alt Reg Order. On the basis of Mr. Smith's calculations, CUB claims that AI is currently overearning by approximately $956 million for AI's intrastate operations.

According to CUB, the Company's own assessment of its 1999 intrastate operating results(which include AI proposed adjustments to intrastate revenues and expenses), also reflects an astounding 24.53% return on common equity or more than double the cost of common equity approved by the Commission in 1994. These results, GCI witness Smith noted, indicate that the present plan has permitted the Company to dramatically overearn, such that rates must be reduced significantly before any new regulatory plan is established.

While AI asserts that rates are just and reasonable because annual overall revenue reductions have been passed through each year since the inception of the price cap plan and the revenue reductions passed through to consumers under the plan exceed what might have occurred under rate of return regulation, CUB finds the testimony on these points unpersuasive.

According to CUB, only a small portion of the cited revenue reductions were applied to residential usage rates. CUB further claims that some residential customers experienced rate *increases* under AI's price cap plan, depending on the calling plan selected. In addition, the Company's reported level of earnings shows that AI is earning more than double the authorized level of intrastate earnings that was adopted by the Commission back in 1994, thus confirming CUB's view that the rates AI charged to its noncompetitive customers declined far less than the Company's actual costs. Finally, AI witness Gebhardt admitted that his tally of a purported $943 million in cumulative rate reductions to customers does *not* include the increases in rates that have accompanied AI's reclassification of "noncompetitive services." (Tr. at 398-399.)

According to the AG, the fact that some prices decreased as a result of the Plan, does not show anything other than that the mechanics of the plan were followed and operated as intended to decrease rates. (AG Initial Brief at 24)

AI witness Gebhardt's comparison of what would have happened to rates under rate of return regulation is flawed, CUB argues, because it assumes the Commission would not have instituted any rate case over the life of the plan. According to CUB, Staff witness Mr. Hoagg indicated that with the rapid growth in demand for telecommunications services provided by AI and the earnings performance of the Company over the life of the plan, it is likely that the Commission would have instituted one or more revenue investigations which may have resulted in aggregate revenue and rate reductions.

While AI argues that the Commission's examination of the justness and reasonableness of its rates should be based on an "affordability" analysis that compares telephone rates with the changes in the consumer price index ("CPI"), wage levels and the rates of other local exchange carriers, on the theory that customers are more interested in the price they pay relative to the value they attach to the service, CUB disagrees.

CUB notes that Mr. Gebhardt chose a comparison of rates of other LECs, and not competitive carriers, for purposes of defending the Company's rate levels. Such is the case, CUB claims, because there is insufficient competition in the local market to provide any other comparison. Examining other LECs' rates is a poor criterion for measuring the justness and reasonableness of AI's rates according to CUB. As noted by GCI witness TerKeurst, AI is one of the lowest cost incumbent LECs in the nation and AI's earnings were are also some of the highest among incumbent LECs. Given its lower costs and higher earnings levels, it is reasonable to expect that AI's rate would be lower than those of other incumbent LECs. Because AI is still the monopoly provider of residential local telephone service, and a comparison of prices of competitors is impossible, CUB believe that the criterion of "affordability" requires an examination of the Company's costs and earnings.

CUB also notes Dr. Selwyn testimony that, if a "competitive outcome" analysis cannot be conducted due to a lack of competitors, then the other principal means by which the justness and reasonableness of AI's rates can be judged is on the basis of the Company's earnings. For example, if AI consistently earns a return on its investment that is well in excess of the rate of return that the Commission would customarily authorize under rate-of-return regulation *and* is higher than would be expected to arise under competitive market conditions, then according to Dr. Selwyn, it is reasonable to conclude that AI's rates are excessive and thus violate the "fair, just and reasonable" requirement. CUB further notes GCI witness TerKeurst observations that, while it may not be possible to determine with precision what rates would have been under rate-of-return regulation, i.e., when rate cases would have been held or with what result, it is clear that Ameritech Illinois would not have been allowed to reap its current earnings levels.

According to CUB, there is no provision in the Alt Reg Order or in Section 13-506.1 of the Act to suggest that the regulatory compact inherent in the approval of alternative regulation includes an open-ended right to unlimited, excessive earnings. If anything, CUB claims, the Alt Reg Order includes numerous provisions that reflect the Commission's desire to monitor the Plan and the Company's earnings in order to assess the Plan's performance. For example, the Commission noted that its decision to exclude earnings sharing from the Plan is not to be construed as a rejection of all earnings sharing mechanisms of the future. The Commission further stated that it would in future review proceedings, entertain evidence and argument of policy considerations for the provision of some forms of earnings sharing in a revised plan. (See Alt Reg. Order at 51).

According to CUB, the statutory requirement that rates be fair, just and reasonable is not limited to noncompetitive services. And, as intervenor witnesses TerKeurst and Selwyn point out, a regulatory plan that produces reclassification of services to competitive with corresponding price *increases* does not further the goal of fostering competition or providing just and reasonable rates.

Further, CUB claims, all of AI's local and intraLATA services are furnished using a common set of network infrastructure and other corporate resources. As noted by Dr. Selwyn, the FCC has concluded that it was not possible to develop jurisdiction-specific estimates of total factor productivity because no economically meaningful separation of state and interstate inputs could be made. This same reasoning, CUB contends, applies to services labeled as competitive and noncompetitive here. And, because the Commission no longer requires detailed cost studies to support "competitive" services, CUB claims that it has no adequate means of determining whether AI is over allocating costs to noncompetitive services and thereby depressing the noncompetitive rate of return, while under allocating costs to competitive services.

CUB notes that when the Commission first approved price cap regulation for AI in 1994, only 7% of the Company's revenues were derived from competitive services yet today, AI reports that about 58% of the Company's intrastate revenues come from competitive services. This massive reclassification effort, CUB maintains, has been accompanied by rate increases for some of these services. As noted by Dr. Selwyn, "(t)he very fact that such rate increases were possible as an economic matter for services that were already priced in excess of their costs and that ostensibly faced actual competition undermines fundamentally the Company's contention that any such competition is present in the first place."

Accordingly, CUB maintains that the Commission should reject AI's proposal to ignore the earnings produced by its competitive services when examining the Company's returns. The AI Plan has not achieved, the all-important requirement that rates be just and reasonable. The preponderance of the record evidence, CUB claims, clearly demonstrates that rates are too high given the Company's reported earnings level.

The City maintains that Ameritech Illinois' current rates are unjust and unreasonable, in part, because the 4.3% X factor that the Commission adopted in the 1994 Order was set too low. As a result, the City claims, the Plan rates produced earnings well in excess of the rate-of-return that the Commission would authorize or which would be expected to arise in an effectively competitive market. According to the City, this ineffective price/earnings constraint, coupled with Ameritech Illinois' dubious reclassification of services (followed by price increases), allowed Ameritech Illinois to achieve a net return on investment in 1999 of 28.49% for intrastate operations and 43.08% return on equity.

Nothing in Section 13-506.1, the City claims, limits this Commission's review to Ameritech Illinois' noncompetitive rates. Rather, Section 13-506.1(b)(4) specifically requires as part of this review proceeding that the Commission consider Section 13-103(a) which mandates that "telecommunications services should be available to all Illinois citizens at just, reasonable, and affordable rates..." 220 ILCS 5/13-103(a). According to the City, Ameritech has reclassified over half of its services as competitive under the Plan and given the ease with which reclassification has taken place and the absence of effective competition for reclassified services, AI has been able to raise the rates of many of these new "competitive" services immediately after reclassification.

If effective competition existed in the local telecommunications market today, as was anticipated in 1994, the City argues, the Commission could compare Ameritech Illinois' rates to those of its competitors to determine whether Ameritech Illinois' rates were just and reasonable. The City notes, however, that AI remains the dominant carrier in the local market and any competitors that exist generally price their services in relation to the prices charged by Ameritech Illinois. Thus, the City argues comparing Ameritech Illinois' rates to those of its competitors serves no useful purpose and cannot be a basis for finding Ameritech's rates to be just and reasonable. Instead, the City maintains, the Commission must determine whether Ameritech Illinois' service prices are just and reasonable based on its realized earnings.

According to the City, the record suggests four possible explanations for the level of earnings produced under the Plan. The earnings increase may have been achieved (1) at the expense of service quality, (2) by aggressive and premature reclassifications of services from noncompetitive to "competitive" followed by price increases; (3) because the current Plan, flowed in either or both (a) an insufficient productivity offset factor, (b) an unduly limited scope (i.e., the price adjustment mechanism was confined solely to services classified as "noncompetitive"); or (4) the actual improvement in productivity was greater than the 4.3% "X" factor imposed by the Commission in the 1994 Order.

There is evidence, City claims, that the Company failed to meet the Commission's set of service quality standards in five of the six years during which the current Plan has been in operation. The City notes, however, that in response to aggressive regulatory intervention (outside the Plan) Ameritech Illinois appears to be on pace to fix its service failures very soon.

The City further contends that, the criteria for service reclassification has not been applied in a way that assures the presence (not simply the hypothetical prospect) of alternative services that can constrain the Company's prices for its reclassified services. The City maintains that the Company has increased prices for some of the reclassified services shortly after such reclassification. Even as to reclassified services for which prices were reduced, the City claims that prices still exceeded the formulaic price that would apply absent reclassification. Finally, City argues that on the basis of data apart from Ameritech Illinois' price behavior, GCI and City witness Selwyn calculated that the 4.3% "X" factor was too low.

The GCI/City contend that Staff witness Hoagg confirmed the propriety of reviewing AI's non-competitive rate and earnings to determine if they were just and reasonable. (Tr. 1223). Staff witness Genio Staranzcak, noted that if the Company believed that its earnings were insufficient, it would certainly seek rate increases. Such testimony, the GCI/City claim, shows that it is not realistic to ignore earnings when evaluating the alternative regulation. Either the earnings are reasonable, and the resulting rates are reasonable, or they are not and adjustments are necessary.

GCI/City disagree with AI's assertion that the productivity offset "flowed through to consumers <u>all</u> of the productivity gains achieved by the Company during the 1995-99 period. They maintain that If the productivity offset had flowed all savings to consumers, one of two things would have happened: (1) AI's rates would have decreased consistent with the 11.06% X factor which Dr. Selwyn determined was the offset necessary to have maintained the Commission's 1994 rate of return, or (2) AI's 1999 test year data would not have shown earnings $276.1 of million (AI calculation), of $824.6 million (Staff calculation), or of $956 million (GCI calculation) greater than their current, reasonable cost of capital.

GCI/City believe that the most obvious and direct method to assess the accuracy of the price cap mechanism is to review AI's rates and earnings using rate of return principles. Using a rate of return analysis to determine what rate and revenue level is reasonable, and the rate cap mechanism to produce the rates being assessed, compares two separate and independent methods. According to the GCI/City, if rate of return regulation would produce rates between $276.1 million and $956 million lower than price cap rates, it is clear that the rates produced by alternative regulation are unnecessarily high and are not just and reasonable.

While AI and Staff would limit the Commission review to whether AI's non-competitive rates are just and reasonable, the GCI/City continue to disagree.

Commission Analysis and Conclusion

Fair, just and reasonable rates is the standard set by law and the goal of all regulatory schemes. The determination as to whether rates meet this objective, however, cannot be made by a comparison and contrast of the earnings to be derived from one regulatory scheme against the earnings produced under a wholly different regulatory scheme. Staff recognizes this fundamental mismatch by noting that alternative regulation plans regulate the price of services rather than a company's earnings.

Staff reminds us that the Plan's going-in rates were determined to be fair, just and reasonable. The Commission agrees with Staff's observation that rates have declined during the term despite modest levels of inflation. In the end, Staff, provides us with a reasonable assessment of rates and earnings in this matter than is wholly compatible with the precepts of alternative regulation. Indeed, Staff's zone of reasonableness test is viable because it cuts both ways. The symmetrical treatment of both robust earnings and under-earnings works in fairness to both the Company and the ratepayer.

Staff also contends, and we agree, that the analysis of fair, just and reasonable rate under the Plan applies only to rates for non-competitive services. We read the statute just this way.

The CUB/AG complaint and the GCI/City position on this review CUB complaint is the same: rates are not reasonable because earnings are higher than initially authorized. That is a premise we cannot accept. The evidence shows that the justness and reasonableness of rates is not inherently a function of the earnings of a company. That is a proposition which underlies ROR but it is inappropriate for alternative regulation. At its most basic, ROR regulation consists of a Commission determination as to what is a reasonable rate of return on the company's equity. The Commission then sets rates at levels designed to produce the target rate of return. Under alternative regulation, the price-cap index assumes the place of general rate proceedings with rates a function of the formula. Earnings are not the primary focus.

In this review of AI's performance under the Plan, the evidence shows that it earned more than the rate of return analysis in 1994 established. When adopting the Plan for AI, however, the Commission recognized the possibility of just such an outcome. Those earnings are the result of a number of variables, both under and outside the control of the Company and, in Staff's assessment of all the underlying circumstances, not outside the zone of reasonableness

The position taken by GCI/City that fair, just and reasonable rates must equate to what would result from a traditional rate case fails in its simplicity as well as in the complexity by which these parties press their claim. Simply put, the comparison which the GCI/City would have be done is neither realistic nor telling for present purposes. The underlying characteristics, incentives and the very nature of the Plan is such that it will not allow any reasoned comparison with the outcome of a ROR analysis.

We accept Staff's analysis and its judgment the Company's earnings are not outside reasonable limits and that rates have remained just and reasonable. This analysis appears wholly consistent with the concepts which underlie alternative regulation. We note that the Company's affordability analysis has some merit and adds to our determination that earnings should not, and will not be our primary focus. To the extent, however, that AI would maintain that earnings are wholly irrelevant under alternative regulation, it is way off the mark.

We would note that service reclassifications, if improper, might have affected rates. But that is a separate matter which is presently being considered in another docket. The outcome of that proceeding, however, may well have implications for the Plan, if it is continued, as well as on rates.

In the final analysis, it is the reasoned judgment of the Commission that noncompetitive rates under the Plan have been, fair, just and reasonable. We have not been shown otherwise. Thus, the statutory requirement we consider here, has been met.

2. Has the Plan Reduced Regulatory Delay and Costs Over Time?

Authority: Section 13-506.1 (a) and Alt Reg Order.

In its 1994 Order, the Commission recognized that traditional rate of return regulation imposed significant costs on all parties involved, with exhaustive 11-month proceedings. The Commission found that price regulation, in contrast, would permit streamlined proceedings and would eliminate regulatory review of the “prudence of incurred costs, equipment replacement and cost of capital”. (Alt Reg Order at 180-81).

AI’s Position

AI takes the position that the Plan clearly met the requirements of the law and the Commission’s expectations. According to the Company, the annual filing process has worked well. It has been very streamlined and rate changes go into effect in three months, and not the customary 11 months.

It makes no sense, AI contends, to count against the Plan the 22 months which it took the Commission to adopt it in the first place given that this was a major and unexplored regulatory change warranting serious review. In AI’s view, none of the usual active participants in telecommunications dockets (the Company, Staff or the Intervenors) could possibly have devoted more resources to the price cap filings than they would have to one or more general rate cases during this period.

While CUB complains that the cumulative amount of time required by the annual filings exceeds that of a general rate case, such a contention is, according to AI, patently untrue. CUB further claims that the SBC/Ameritech merger and competitive, classification proceedings would not have occurred under rate of return regulation. According to AI, however, SBC made clear in the merger proceeding that the driving force behind the merger was the need to achieve the scale and scope of a global telecommunications company and thus, only financially punitive regulatory climates in all five Ameritech states (not just continued rate of return regulation in Illinois) would likely have changed SBC’s decision. AI further contends that competitive classifications actions have nothing to do with the Plan. It states that these reclassifications could and would have been made regardless of what form of regulation applied.

Staff’s Position

According to Staff, here is little doubt but that the Plan has resulted in reduced regulatory delay and costs. This is especially so, Staff maintains, given that rate reductions thereunder have been automatic. (Staff Initial Brief at 32)

CUB’s Position

CUB contends that, as GCI witness Dr. Selwyn observed, the Plan has not met the objective of Section 13-506.1(a). To begin, CUB notes that the Alt Reg. proceeding took 22 months to complete. In addition, CUB notes that a 3-month proceeding occurs each year whereby noncompetitive rates are set. To this, CUB would add both the time expended on the SBC/Ameritech merger proceeding and the proceeding to challenge premature classification of services from noncompetitive to competitive. These proceedings, CUB argues, only occurred because AI was under price cap regulation and may well have been avoided had the Company remained under rate of return regulation. When considered cumulatively, CUB argues, these proceedings significantly surpass the amount of time that would be spent on three, 11-month rate cases and show that the AI price cap plan has *not* reduced regulatory delay and costs over time.

Commission Analysis and Conclusion

CUB's position on this item is simply not credible. The standard is the reduction of delay and costs "over time" and, as such, does not count the 22 months spent at the outset to establish a plan. We are not persuaded that either the merger or reclassification proceedings are viable considerations. Moreover, the measure includes not only time but the breath and depth of the work involved. The annual filings here produce an outcome for each year of the Plan without the intensity and effort required in rate cases. It is thus only reasonable to conclude that the Plan has satisfied this requirement.

3. Has the Plan Encouraged Innovation in Telecommunications Services?

Authority: Section 13-506.1(a)(1) and Alt Reg. Order.

In 1994, the Commission expected that the prospects of higher earnings would incent the Company to aggressively develop and offer new services; that the removal of prudency reviews would encourage the Company to be more innovative and take more risks; and that the ability to change prices without regulatory involvement would allow the Company to experiment more in the marketplace. (Alt Reg Order at 181.)

AI's Position

Ameritech Illinois contends that it has been more innovative with new services being an important factor in generating revenue growth. AI provides, as an example, its offering of "Privacy Manager" which allows customers to pre-screen their calls and eliminate telemarketing or other unwanted intrusions. Ameritech points out that it was the first RBOC in the nation to offer this service which is now widely imitated. The Company also claims to have experimented in the marketplace with a large number of promotional offerings and the introduction of optional calling plans. Today, AI contends, a substantial portion of its residential customers take service under one of these plans.

In response to Dr. Selwyn's apparent belief that the Company's usage rate structure should be less distance-sensitive, AI points out that this is a rate design judgment call, not a matter of "innovation". So too, AI notes, Dr. Selwyn's claim that Ameritech Illinois's roll-out of DSL has been too slow ignores the fact that this service is offered by Ameritech Illinois' affiliate AADS. The Company argues that, as in other instances, AADS' deployment record cannot be counted against Ameritech Illinois.

The complaint that most "innovations" can be traced to equipment vendors and not Ameritech Illinois does not make it a Company failing, AI maintains. Indeed, the point that vendors develop the switch hardware and software which enables new features and functionalities for the entire industry, was first set out in AI's own testimony. (See, Am. Ill. Ex. 1.1, p. 51). There, Mr. Gebhardt explained that the development of truly "new" services depends on the capabilities of the switching fabric itself, which has been the province of switch vendors. Short of becoming an equipment manufacturer, hardly a realistic alternative, AI maintains that its service introduction record is solid.

CUB's Position

CUB suggests that no more innovation occurred under the Plan than would have otherwise under rate of return regulation. As pointed out by City witness Dr. Selwyn, CUB maintains that basic telephone service in Illinois today is hardly different than that which existed in 1994. According to CUB, whatever "enhancements" or "innovations" in services have taken place are traceable primarily to equipment vendors rather than to specific AI initiatives.

CUB further contends that despite the fact that the costs of individual telephone calls are virtually distance-insensitive, and the costs of network usage have declined dramatically over the past decade, AI continues to make unwarranted distinctions in name and price in local and toll calls. In addition, CUB claims, AI has actually increased its rates for certain local and intralata calls. Further, CUB notes that although DSL technology has been around for a number of years, it is available in only a limited number of exchanges, and to only a limited number of subscribers within those exchanges to only a limited number of subscribers. CUB also notes that AI has chosen to suspend its "Project Pronto" deployment of DSL service. According to CUB, the Plan has *not* encouraged innovation in telecommunications services.

Commission Analysis and Conclusion

As a practical matter, innovation is the life-blood of any company and one feature it would not intentionally neglect. While the innovations which Ameritech described are limited, there is nothing relevant on record to suggest that the Plan failed to encourage innovation. Thus, this provision is satisfied.

4. Did the Plan Respond to Changes In Technology And The Structure Of The Telecommunications Industry That Are, In Fact Occurring.

Authority: Section 13-506.1(b)(3) and Alt Reg. Order.

In its 1994 Order, the Commission found that that the Plan met this objective because Ameritech Illinois' market environment would be increasingly competitive; that significant changes in technology were taking place; and that price regulation was better suited to these changes than rate of return regulation. (Alt Reg Order at 187-88.)

AI's Position

AI contends that the market environment has increasingly become more competitive with many more, as well as many more diverse, providers today than there were in 1994 and these competitors are successful in winning business from Ameritech Illinois. AI notes that in 1994, CLECs like MFS and TCG were just beginning to offer switched services to customers in Ameritech Illinois' service territory. Today, AI maintains, the Commission has certificated at least 59 CLECs, which collectively use a mix of resold services, UNEs and their own facilities to provide local exchange service. These CLECs, according to AI, include major IXCs like AT&T and MCI, fixed wireless competitors, cable companies and data CLECs. The scope of local competition has increased to the point, AI contends, where CLECs now have investments in place that can readily serve most of Ameritech Illinois' business and residential customers.

So too, AI maintains, there have been some significant changes in technology. An explosion in data traffic, driven in significant part by the Internet, is transforming the industry and requiring significant changes in Ameritech Illinois' network and network architecture. In 1994, AI contends, the Internet was just beginning to be used for commercial applications and voice communications constituted 87% of the revenue generated by the network. Today, however, evidence shows that business customers are restructuring their operations around the Internet and 45% of U.S. households have Internet access. AI explains that traffic on the network has fundamentally shifted from voice to data, and Internet transactions are substituting for voice transactions. Further, AI notes, wireless capacity has expanded rapidly and prices have declined, as customers increasingly substitute wireless for wireline calls.

As such, AI believes that the marketplace dynamics which drove the adoption of price regulation in 1994 are even more compelling today. Increased pressure from competitors using different, and more advanced, technologies than exist today in the Company's network will require appropriate responses for AI to keep competitive.

In contending that the Plan was not responsive because the residential local service marketplace is not yet fully competitive, AI believes that CUB and the AG misperceive the Commission's expectations for the Plan. According to AI, the Commission adopted price regulation because it would adapt to marketplace changes over the long run -- not just for the next five years. To be sure, AI contends, the Commission imposed a five-year rate cap on residential services because it assumed that residential local service would <u>not</u> become fully competitive and would <u>not</u> become subject to marketplace pricing constraints during this period. AI notes that the Commission specifically stated that this rate cap would allow it to "grapple with the complex social and economic issues associated with new technologies and emerging competition" during this period. (See, 1994 Order at 65 (emphasis added).

AI takes issue with the CUB/AG complaints as to the inadequacy of upgrades to its network. The record demonstrates, AI contends, that it has invested in the technology required to bring advanced services to this state. AI maintains that the Attorney General's claim that pair gain technology (digital loop carrier systems) disadvantages customers is incorrect, noting that this technology has been widely used by local exchange companies since the 1980's and provides the most cost effective means of provisioning a high quality outside plant network. AI further observes that the demand for high-speed Internet access is a relatively recent phenomenon which customers can obtain from any of the many alternative providers.

More to the point, AI claims, CUB and the Attorney General flatly ignore the risks associated with technological change and the Commission's concern that ratepayers be protected from those risks. (See, Alt Reg Order at 87-88.) The record shows, AI maintains, that technology is changing at a rapid rate and that, over the long run, the Plan will better protect customers from the financial consequences of that change than rate of return regulation.

CUB's Position

While AI witness Gebhardt pointed to the Company's digital network as evidence that the plan has delivered technological advancements to AI's customer base, CUB is unimpressed. The Company's testimony in the original Alt Reg Order Docket, Cub claims, shows that AI would have only 18 analog switches (the precursor technology to digital switching) remaining at the end of 1994. (See Alt Reg. Order at 150.) With or without price regulation, the Company anticipated that it would complete the analog switch replacement work by the end of 1997. Hence, CUB argues, the Company's delivery of its end-to-end digital network is not evidence of, or attributable to, any alternative regulation success.

Even if it is true that the Company, as AI witness Gebhardt testified, has spent millions of dollars opening its networks to competitors, CUB claims that this has not been enough to alter in any meaningful way the competitive nature of the local exchange marketplace, particularly for residential customers. In any event, CUB argues, the additional investment made by AI to spur competitive growth has been more a function of Commission decisions and federal law, than alternative regulation. As such, CUB relies on Dr. Selwyn's observation that AI's testimony is absent any evidence showing that it addressed changes in technology any differently under the price cap plan than it would have under rate-of-return regulation.

Commission Analysis and Conclusion

New wireless technology and the internet explosion came to prominence during the Plan term we here examine. The Federal Communications Act was also adopted in this time frame. Without question, AI has had to respond and adapt to all of these changes and it must be prepared to address new challenges in the near future.

5. Has the Plan Produced Efficiency Gains and Cost Savings

Authority: Sections 13-506.1(b)(5); 13-506.1(a)(3) and Alt Reg Order.

The law requires findings that the Plan will promote efficiency and that ratepayers will benefit from any efficiency gains, cost savings and productivity improvements arising out of the regulatory change. In 1994, the Commission concluded that the Plan would provide Ameritech Illinois with incentives to implement cost saving efficiencies and new services, because of the potential for higher earnings if the Company were successful. The Commission further determined that ratepayers would benefit from these efficiencies and new services through the X factor, which would apply regardless whether the expected productivity gains were achieved. (Alt Reg Order at 188-89.)

AI's Position

AI maintains that the Plan did provide it with new incentives to become more efficient. It not only maintained, but increased, its productivity over the term of the Plan, and improved its performance on standard measures of efficiency in the industry. Moreover, AI asserts that the X factor was higher than Ameritech Illinois' total productivity gains such that consumers reaped all of the gains which Ameritech Illinois achieved, as well as some that it did not, which more than satisfies the statutory standard. Further, AI insists that its efficiency gains were not achieved at the expense of service quality. If kept in a proper perspective, AI maintains that its service quality was generally excellent during the 1994-99 period.

Arguments whereby CUB and the Attorney General contend that ratepayers did not appropriately benefit from the efficiency gains and cost savings which resulted from the Plan rest on a commingled view of noncompetitive and competitive service rate changes and earnings which AI views as improper. According to AI, the Plan's performance has to be assessed in terms of the services to which it applied. It is undisputed on record, AI contends, that the X factor flowed through to customers of Ameritech Illinois' noncompetitive services all of the productivity gains which the Company achieved.

CUB's dismissal of the benefits associated with increased sales of vertical services ignores the fact that customers like and use these products -- if not, they would not buy them in the first place or would cancel them after a few months' experience. Further, CUB's claims that such increased sales were due to the merger and not the Plan are wrong, AI contends, since the financial analyses in this proceeding are based on 1999 data whereas the merger did not close until September of that year. Hence, vertical service sales during the Plan are not attributable to SBC.

CUB' Position

CUB challenges AI witness Gebhardt's claim that since the inception of the plan, the Company has focused on customer-oriented marketing strategies and streamlined its decision-making processes, thereby promoting efficiency and making AI a more responsive organization. From the residential customer perspective, as viewed by CUB, these marketing achievements are little more than the promotion of Caller ID and other vertical services – the implementation of which AI and SBC characterized as the "best practices" that would result from the merger, and not a byproduct of alternative regulation. As for the claimed improvements in the Company's management structure, CUB claims that residential customers clearly have not been the beneficiaries given the deteriorating service quality linked to AI.

CUB notes Dr. Selwyn's observation that any efficiency gains and cost savings arising out of the regulatory change, to the extent they exist, can only benefit AI ratepayers if they are passed on to them. CUB claims that because overall annual rate reductions triggered by the price cap formula have been accompanied by increases in rates reclassified as competitive, or bundled as new services, and left outside of the pricing constraints of the plan, - any alleged efficiency gains or cost savings have not benefited AI's captive business and residential customers.

GCI and City further dispute the suggestion that consumers benefited from efficiency gains, and that the price index mechanism resulted in rate reductions that exceeded AI's productivity. According to GCI, if the rate reductions required by the price index exceeded AI's cost savings and productivity gains, one would expect its return on rate base and its return on equity to be lower than it was at the inception of the plan. This has not happened, GCI maintains, and AI has retained the vast majority of the benefits from its productivity and efficiency gains, sharing only the amount required by the price index and not more irrespective of its actual cost savings. In short, the GCI/City maintain that the Company has presented no evidence that the approved alternative regulation plan resulted in increased efficiency for AI.

Commission Analysis and Conclusion

The Commission relied on the X factor in the formula to ensure that efficiency gains and cost savings benefited customers. The X factor worked as expected and thus the Plan met this requirement, but only in part. If we take a broader view, there are some issues.

6. Has the Plan Served to Prejudice Or Disadvantage To Customers

Authority: Sections 13-506.1(b)(7); 13-103(d) and Alt Reg Order.

Under Section 13-506.1(b)(7), an alternative plan of regulation must not unduly or unreasonably prejudice or disadvantage any particular customer class, including telecommunications carriers. In addition, the Commission must consider whether the Plan would result in discrimination or cross-subsidies under Section 13-103(d). In its 1994 Order, the Commission concluded at that time that the basket structure would ensure that all customer classes would be treated equitably. The Commission also determined that the pricing flexibility limitations and residential price cap would protect residential customers; and that carriers were further protected by the requirement that intrastate carrier access rates could not exceed interstate carrier access rates. (Alt Reg Order at 190-91). With respect to discrimination and cross-subsidies, the Commission relied on the reasonableness of the Company's going-in rates, as well as the Imputation and Aggregate Revenue Tests. (Id. at 185).

AI's Position

AI maintains that that the basket structure and residential rate protections functioned precisely as the Commission intended because: (a) all of the rate reductions required by the Plan were flowed through equitably to each customer group; (b) the limits on pricing flexibility, combined with the low rate of inflation over this period and the residence rate cap, more than protected consumers of noncompetitive services from any rate increases and those rates declined; (c) there were no rate-related complaints of any significance over the Plan's initial term; and (d) all of the statutory service cost and pricing rules continued in effect and the Company has complied with them.

AI disputes Dr. Selwyn's claim that the Plan disadvantaged noncompetitive service customers because the productivity offset "was woefully insufficient and misspecified". According to AI, the offset in the Plan today was based on Ameritech Illinois' own productivity performance and Dr. Meitzen's updated Company-specific analysis for the 1992-99 period demonstrates that it was, if anything, too high. (Am. Ill. Ex. 1.1, pp. 29-30). This analysis, AI maintains, was not contested by any party to the proceeding.

AI further asserts that the concept of prejudice involves the favoring of one customer class at the expense of another and, under Section 13-506.1(b)(7), the Plan may not unduly prejudice "any particular customer class" (emphasis added). Hence, AI maintains, it makes no sense from either a logical or statutory perspective to claim, as does CUB, that the Plan "unduly disadvantaged noncompetitive service customers as a whole.

AI further notes that CUB and the Attorney General erroneously recast their complaints about lack of competition, service quality, earnings, and the treatment of calling plans under the basket structure as “prejudice” issues. Again, AI explains, to the extent these complaints have any merit -- and the Company believes that they do not -- they would impact all noncompetitive customers equally and, thus, would not constitute prejudice or disadvantage under Section 13-506.1(b)(7).

AI notes the Attorney General complaint that Ameritech Illinois’ rate design decisions under the Plan have primarily benefited customers who make use of the Company’s network. The AG would have preferred reductions in network access lines, which are subscribed to by customers who make little or no use of the network. This, AI maintains, does not constitute “prejudice” or “disadvantage”. The Company made clear in 1994 that residential network access lines were underpriced and that it had no intention of reducing those rates under the Plan. (See, Alt Reg Order at 63, 68). And, as evidenced by the Company’s rate rebalancing proposal, circumstances have not changed. The Company’s consistent pricing policy over the last seven years relative to this issue has not been “prejudicial” within the meaning of the statute. In AI’s view, it is not unreasonable for rate reductions to flow more heavily in the direction of customers who actually make use of its network, as compared to customers who do not. Such a result, AI contends, increases overall consumer welfare.

GCI/City’s Position

CUB believes that the Company’s skyrocketing earnings, deficient service quality, and propensity to prematurely classify services as competitive (with increased rates for those services), all conspire to show that the plan has unduly disadvantaged noncompetitive service customers as a whole. According to CUB, residential customers have seen charges for Band C usage climb steadily since the inception of the plan and business customers have had basic network access and all usage services reclassified as competitive, with corresponding rate increases.

On the basis of the Company’s exorbitant level of earnings under the plan, CUB views it clear that the price cap formula’s insufficient productivity offset, and the lack of an earnings sharing mechanism has produced rates that are higher than would have occurred under rate-of-return regulation, all other things being equal. CUB also considers the failure of any measurable level of competition to develop in the local market, as evidence that competitive carriers likewise have been disadvantaged under alternative regulation.

The GCI/City agree with AI that the basket structure and pricing flexibility limitations were intended to protect consumers from undue or unreasonable disadvantage under the plan. They dispute, however, AI’s position that the basket structure and residential rate protections functioned precisely as the Commission intended. GCI witness Charlotte TerKeurst and Staff witness Koch testified that AI manipulated the basket structure and the limitations on pricing flexibility by treating the rates for calling plans as "new services" under the plan, despite the fact that they simply repackaged and repriced residential Bands A and B usage rates. As Staff pointed out in its Initial Brief, calling plans account for over 90% of AI's revenues from new services. (Staff In Br. at 26). These revenues, the GCI/City contend, are from services that should have been included in the residential basket, and subject to the same pricing limitation applicable to other residential basket services.

The basket structure was intended to protect all classes of customers and insure that they all receive rate reductions as a result of alternative regulation. AI, however, has increased the rates for residential usage by offering calling plans as "new services" and has not decreased access charges or band A calling rates during the Plan. The GCI believe it clear that customers of "plain old telephone service" who purchase simple access and make band A and B calls, have not received any benefits from AI's efficiencies or alternative regulation because their rates have remained the same despite substantial cost reductions.

Commission Analysis and Conclusions

Prejudice or discrimination is a concept which calls for a comparison. It requires a showing of difference in treatment under the same or similar circumstances. We have not been provided with such a showing.

In addition to prejudice, however, we are directed to consider disadvantages. On the basis of Staff's account, the Commission believes that the service baskets which we structured have not operated as expected. Hence, we find that this requirement has not been fully satisfied. If the Plan is to be continued, we will surely give further attention to these matters.

7. Whether There Has Been Broad Dissemination of Technical Improvements and Economic Development

Authority: Sections 13 - 506.1(a)(4); 13-506.1(a)(5); 13-103(f) and Alt Reg Order:

Sections 13-506.1(a)(4), 13-506.1(a)(5) and 13-103(f) require the Commission to consider whether alternative regulation plans will facilitate the broad dissemination of technical improvements to all classes of ratepayers and enhance the economic development of the State. In its 1994 Order, the Commission concluded that price regulation provided the appropriate incentives to encourage market-based investment in infrastructure; that the Company had made a $3 billion commitment to grow and modernize its network; and that, because most of Ameritech Illinois' plant-in-service is used to provide service jointly to all customer classes, all classes of customers would benefit from this investment. (Alt Reg Order at 182, 183). The Commission also determined, based on economic analyses presented in that proceeding, that there was a generally positive relationship between network modernization and economic development.

AI's Position

Ameritech Illinois contends that it not only met, but exceeded, its $3 billion commitment by spending $3.7 billion. Those investments AI contends, facilitated the development of an advanced telecommunications infrastructure. Today, AI maintains all of Ameritech Illinois' customers have digital switching capabilities available to them. So too, virtually all of the Company's interoffice facilities are now fiber. Further, over 90% of the Company's access lines have access to ISDN. In addition, SS7 deployment is complete and 65% of the Company's central offices have been equipped with the AIN platform. All of these technologies, AI claims, are important building blocks for advanced services.

Ameritech Illinois notes that it also spent millions of dollars opening its networks to competitors. It contends that customers benefit from the expanded choice of alternative service providers. It notes further that the positive relationship between price regulation and network modernization which the Commission relied on in 1994 has now been further validated by a NARUC/NRRI study based on empirical data from jurisdictions throughout the United States. (Am. Ill. Ex. 4.2, at 3-4). Accordingly, AI asserts, the Commission can conclude that the Plan has enhanced economic development in the State.

With respect to Ms. TerKeurst contentions that AI's service quality problems demonstrate that it invested in high margin services/customers at the expense of basic service customers, the Company notes that there is no evidence whatsoever to support such a claim. In fact, AI contends, because the Company's network primarily consists of common plant, it is virtually impossible for to do as Ms. TerKeurst suggests. And if any customer group benefited disproportionately from Ameritech Illinois' network investments, AI argues, it is the CLECs -- who are most definitely <u>not</u> the Company's "high margin services/customers".

By subtracting depreciation accruals associated with existing plant from the $3.7 billion of new investment over the five-year term, Dr. Selwyn arrived at the proposition that Ameritech Illinois only invested a "net" of $300 million in its network and, therefore, is not infusing new capital into its business. This proposition, AI contends, has no basis in any legitimate financial or economic theory. Much like any capital intensive company, AI claims, it incurs substantial depreciation expense which reflects both wear and tear as well as technological obsolescence. The relevant measure of Ameritech Illinois' investment in its network is the $3.7 billion and not the net figure cited by CUB. According to AI, the Commission ignored Dr. Selwyn when he advanced a similar argument in the 1994 proceeding.

CUB and the Attorney General claim that Ameritech Illinois should have demonstrated that its network investment promoted economic development with more specificity. The relationship between network investment and economic development however, AI claims, can only be established at a broad, macroeconomic level. AI observes that the GCI's own witness, Dr. Selwyn testified that he was not expecting the Company to establish a linkage between specific network investments and economic development. While CUB also suggests that Ameritech Illinois was obligated to duplicate the economic analysis provided in the 1994 docket in this proceeding AI contends that nothing in the Commission's Alt Reg Order supports this claim.

The Attorney General and Cook County argue that Ameritech Illinois has failed to invest in aspects of the network which benefit POTS service noting, for example, that Project Pronto does little to benefit POTS customers. These arguments, AI contends, fundamentally misrepresent Project Pronto which is not a "DSL project" but rather an overall network modernization program which benefits all customers. In fact, AI points out, because the DSL aspects of Project Pronto are currently being deferred, Project Pronto now benefits only POTS services. (Tr. 1989-92).

CUB's Position

According to CUB, the Company presented no evidence to show that any technical improvements realized since 1994 would not have been achieved and spread over all customer classes if it had been operating under rate of return regulation. As pointed out by Dr. Selwyn, CUB claims that the $3.7 billion that AI invested over the term of the plan was not "new" investment, but was largely funded by ongoing depreciation charges and thereby represents the replacement of existing, "worn out" equipment rather than an infusion of new capital. Because it recorded a total of $3.4 billion in intrastate depreciation accruals over the 1995–1999 time period, AI actually made only $300 million in net investment according to CUB.

In any event, CUB claims, the $3.7 billion in investment claimed by the Company has not been sufficient to maintain basic service quality where AI did not target sufficient amounts into its basic local network, particularly to its outside plant, to ensure timely availability of network access – in new housing areas with high growth rates. According to CUB, executives at SBC, (AI's corporate parent), conceded that point to the investment community by blaming service quality failures on Ameritech's "lack of maintenance and capacity in the outside plant." (See, GCI Ex. 2.0 at 68-69). Neither AI witnesses Jacobs or Gebhardt, CUB notes, made mention of growth in the number of network access lines available to end users and, in addition, AI has chosen to suspend its "Project Pronto" deployment with respect to DSL service.

CUB further claims that the Company failed to provide a single example of economic development in this State that was a direct result of the AI price cap plan.

The Company's assessment of its meeting the $3 billion commitment is suspect, CUB maintains, given that the majority of the investment represents replacement of worn equipment that, absent any evidence to the contrary, would have occurred under rate of return regulation. Thus, according to CUB, the Commission cannot assume that the plan has enhanced economic development simply because AI fulfilled its $3 billion investment commitment.

In CUB's view, the record evidence belies AI's claim that the plan has successfully facilitated any broad dissemination of technical improvements to all classes of ratepayers.

Commission Analysis and Conclusion

In 1994, the Commission concluded in the Alt Reg Order that there was a generally positive relationship between price regulation and network modernization, and between network modernization and economic development. We continue to believe in the worthiness of this proposition. In doing so, we take account of the investment promised and the Company's fulfillment of that commitment

The Commission further observes that economic development depends on the availability of telecommunications service of sufficient quality and quantity offered by a variety of carriers. As such we cannot disregard the investments AI made in opening its network to competitors. On the whole and in these premises, the statutory requirements have been fulfilled.

8. Competition

Authority: Sections 13-103(b) and Alt Reg Order.

Under Section 13-103(b), the Commission must consider whether any alternative regulation plan will promote the legislative goal of allowing competition to substitute for certain aspects of regulation, where consistent with the protection of consumers. In its 1994 Order, the Commission concluded that the Plan would further this goal, because price regulation better reflects the operating freedoms and constraints faced by competitive companies and reduces the economic burden of regulation generally. (Alt Reg Order at 184).

AI's Position

While City witness Dr. Selwyn contended that the Plan failed because it did not actually further local competition as measured by competitive entry and competitors' market shares, AI maintains that this position has no basis in the statute, economic theory or regulatory policy. By its very terms, AI claims, Section 13-103(b) addresses the elimination of unnecessary regulatory oversight and constraints, not promoting competition per se.

AI explains that price regulation is fundamentally a retail plan which governs the pricing of Ameritech Illinois' noncompetitive services to consumers and it establishes the governance structure relative to retail service quality, network investment and financial performance. It is not a wholesale plan. According to AI, price regulation plans do not, of themselves, either encourage or discourage the development of competition, except to the extent that they produce more efficient price signals to potential competitors. Indeed, AI notes, the original pioneering work on the merits of price regulation assumed a monopoly environment whereas now economists and regulators have concluded that price regulation is better adapted (than rate of return regulation) to the transition from monopolies to competition. In other words, AI claims, it makes no more sense to expect price regulation to promote competition than for rate of return regulation to do the same. In any event, AI maintains, it is uncontroverted that there is more competition today than there was in 1994.

AI further disputes Dr. Selwyn's claim that the Plan had actually harmed competition by allowing Ameritech Illinois to shift "costs out of its 'competitive' services and onto noncompetitive services -- including such bottleneck items as switched access and unbundled network elements...". (City Ex. 1.0 at 30-31). Nothing of the kind happened according to AI, and no party produced a shred of evidence to show that costs have been misallocated. Indeed, AI states, switched access rates declined more rapidly than any of Ameritech Illinois' other rates over the term of the Plan and were recently slashed by another $33 million as a result of Dockets 97-0601/0602. Further, AI contends, UNE rates were set at a very low level in 1997 based on TELRIC studies and they have not increased since then. In short, AI maintains, the Plan did not have and could not possibly have had a negative impact on any of these services.

AI notes GCI witness TerKeurst's claim that the Plan impeded competition, because the Company reclassified services as competitive and raised their prices. This argument, AI contends, posits the relationship between price changes and competition precisely backwards. According to AI, competitors are attracted to market segments and services where there is a reasonable opportunity to make a profit. Put another way by AI, price increases provide competitors with more, not less, incentive to enter.

Whereas the GCI/City continue to complain that residential competition has not developed sufficiently this is not, AI asserts, in anyway attributable to the Plan. According to AI, these parties ignore the numerous, complex factors which have contributed to the slow growth in residence lines served by competitors, i.e., low profit margins in the local exchange business relative to other CLEC business opportunities; strategic decisions by the IXCs; and unrealistic regulatory expectations. Despite these factors, AI claims that the CLECs have recently demonstrated a renewed interest in serving residence customers in Illinois. AI further observes that the GCI's intense concern with the level of competition simply cannot be squared with its proposed $1 billion rate reduction, hundreds of millions of which result from imputed revenues and/or disallowances which bear no relationship to financial reality. If these adjustments were adopted, AI believes that they would disincent all competition, including efficient competition. While the GCI want both uneconomically low consumer rates and competition, AI contends that this is not how the marketplace works.

Staff's Position

Staff notes that the transition to competition has not, in fact, taken place nearly as quickly as the Commission apparently believed, and presumably hoped that it would. It contends, however, that this factor be given "limited consideration at most." (Staff Initial Brief at 31).

GCI/City's Position

The City contends that one of the State's major policy goals, i.e., promoting competition, has not been furthered by the Plan. It claims that the level of competition in the local exchange services market is extremely limited such that the vast majority of residential customers and a substantial number of business customers still lack meaningful competition. According to the City, the combination of the Plan's incentives, the Company's reaction to those incentives, and the ineffectiveness of service quality protections have acted to hinder the growth of competition.

The AG further asserts that the Plan has neither led to increased competition nor seen competition constrain monopoly profits.

Commission Analysis and Conclusion

We see no casual connection between the Plan and the furtherence/hinderence of competition in the way that GCI and City attempt to frame the issue. The Plan simply does not have such powers. The conclusory arguments presented do not consider or discuss all of the essential variables for the premise, including that the rates generated under the Plan in Illinois may have deterred incoming hopefuls seeking high profits. To be sure competition in the residential local markets has not opened as quickly or extensively as the parties or the Commission would have desired but we also cannot deny its growth. Nor can we conclude other than that this statutory goal, if properly construed, has been met.

9. Service Quality

Authority; Sections 13- 506.1(b)(6); 13-103(c) and Alt Reg Order.

Under Section 13-506.1(b)(6), the Commission must find that an alternative plan of regulation will "maintain" the quality and availability of telecommunications services offered by the applicant carrier. The Commission must also consider whether the plan will disrupt the telecommunications system or consumer services under Section 13-103(c). In its 1994 Order, the Commission found that the then current quality of service provided by Ameritech Illinois was "fully satisfactory". The Commission concluded that the service quality component of the price index, which included penalties, would provide Ameritech Illinois with incentives to maintain service quality. The Commission also concluded that the incentives to invest in its network and the pricing restrictions in the Plan would ensure the availability of services to consumers. Finally, the Commission concluded that nothing in the Plan would change the way Ameritech Illinois delivered service to its customers. (Alt Reg Order at 184, 189-90.)

AI's Position

On the whole, AI contends, service quality improved significantly over the first five-year term of the Plan—the principal exception being the measure for out of service over 24 hours ("OOS>24"). During that term of the Plan, AI notes that its performance improved for seven of the eight current benchmarks.

AI observes that Staff witness McClerren focused on so-called monthly "misses" in his direct testimony. Aside from OOS>24, however, monthly data confirm that Ameritech Illinois' performance has improved steadily under the Plan. For the other seven (7) measures, AI claims its performance exceeded the benchmarks for 399 of 420 monthly data points (95%). The number of monthly "misses" fell steadily between 1994 (17 misses) and 1999 (four misses). Considering that those benchmarks were based on annual, not monthly, performance during 1990-91 AI claims, that is a remarkable record.

In his rebuttal testimony, Mr. McClerren suggested comparing the average level of performance prior to the adoption of the Plan (using data for the periods 1990-94 and 1990-91) to performance since the Plan was adopted (1995-2000). Those comparisons, AI confirms, confirm that performance has improved substantially, again with the single exception of OOS>24.

AI notes that Staff and GCI continue to focus primarily -- indeed almost exclusively--on two service quality issues: (a) performance for the measure Out of Service Over 24 Hours ("OOS>24") and (b) the more generalized installation and repair problems during the second half of 2000. Ameritech Illinois does not dispute its failures regarding those issues, nor has it minimized the seriousness of those failures. It would, however, direct the Commission to consider on this review whether the Plan on the whole succeeded in maintaining service quality. If service quality performance is considered for all measures over the entire period of the Plan, AI maintains, it is clear that the Plan's successes outnumber its failures by a large margin. This is true, AI contends, even if one measures the success of the Plan precisely in the ways that Staff and the GCI allege that the Plan should be judged.

Staff witness McClerren testified that the success of the Plan should be measured, at least with respect to the measures in the current Plan, by comparing performance before and after the Plan was adopted. He compared the years 1995-2000 to the years 1990-91 and 1990-94 respectively, but only performed this analysis for OOS>24.

The results for the other seven measures, AI contends, all show steady improvement over the initial term of the Plan. Indeed, AI claims, many of the most important measures of service quality improved by large margins. For example, Trouble Reports per 100 Access Lines, - the best overall measure of network performance in AI's view - improved by more than 30% from 1990-94 to 1995-2000. So too, AI argues, the other measures improved over that period by margins ranging from roughly 20% to 100%. Considered on the basis of Staff's approach, AI contends, most measures of service quality have improved markedly.

GCI witness TerKeurst testified that, to get a more complete picture, one must also consider measures of service quality other than those included in the Plan. She, did not actually perform that analysis, AI claims, on the grounds that no pre-Plan data were available for measures outside the Plan. On the basis of data submitted by CUB (in its 1996 service quality complaint case), AI notes, the comparison which Ms. TerKeurst suggests to show that service quality has not declined, but instead improved since the Plan was adopted. Data gathered since the adoption of the Plan are either consistent with, or better, than pre-Plan data for all such measures for which data are available: Business Office Answering Time, Repair Office Answering Time, Repeat Trouble Rate (Installation), Repeat Trouble Rate (Repair), and Missed Repair Appointments. Thus, AI maintains, service quality also improved based on the approach suggested by Ms. TerKeurst.

As for OOS>24, Ameritech Illinois does not deny it has struggled to comply the Commission's five-percent standard which it notes to be a very demanding benchmark. Nevertheless, Ameritech Illinois recognizes its responsibility to comply with this measure and is committed to meeting it. Its commitment, AI claims, is reflected in the sharp drop in OOS>24 cases, - from an average of 14.1% in 1995-97 to an average of 7.9% in 1998-99 - approximately the same level at which the Company was performing before the Plan was adopted. With the increases in network staffing and spending, Ameritech Illinois believes it is on track to comply consistently with this benchmark, as its recent performance shows. (AI requests that administrative notice be taken of its recent performance data, but it has not proceeded as required under the Commission's Rules of Practice.)

With respect to the installation and repair delays that occurred in the second half of 2000, Mr. Hudzik testified that such problems were the result of retirements by an unexpectedly large number of network employees in 1999, coupled with rising workloads and inclement weather.

While certain of the parties suggest that a lack of network facilities also contributed to the installation and repair problems in 2000, AI notes that the record contains little, if any, evidence that the network itself is deficient. Indeed, Performance for Trouble Reports per 100 Access Lines, - the most important measure of network performance in AI's view - improved significantly under the Plan, (from an average of

2.92 for 1990-94 to an average of 2.02 for 1995-2000). In year 2000, AI notes, only 1.81 access lines per 100 were out of service. Dial Tone Within Three Seconds and Trunk Groups Below Objective - which also measure network performance - improved to a point that problems are virtually extinct, such that Staff now proposes to eliminate both of those measures.

Furthermore, AI contends, its installation and repair performance has improved rapidly as with new hirings. Such improvement, AI contends, would not have been possible if adequate facilities were not available. AI maintains that all of this evidence shows that headcount losses and not inadequate network facilities, led to the installation and repair delays which occurred in the second half of 2000. Mr. Whitacre's comments, quoted by the GCI, are not to the contrary, AI claims, as Mr. Hudzik explained:

> "[T]o the extent that additional infrastructure investments could have offset the impact caused by the loss of much of our workforce, it might have mitigated some of the service problems experienced in 2000. However, the more immediate problem was the effect of construction forces that typically are devoted to infrastructure improvements and expansion to address the daily repair and installation loads, which were building due to loss of many of our technicians. I see nothing in Mr. Whitacre's statements that would be to the contrary. In fact, Mr. Whitacre specifically noted that the problem was being addressed by hiring additional technicians." (Am. Ill. Ex. 12.1, p. 12).

AI observes that while Cook County appears to agree that headcount was the problem, it would attribute the loss of headcount to post-merger cost cuts with early retirement packages and other incentives to retire some of its most experienced managers and technicians prior to the 'unanticipated' exodus that led to the service problems in the second half of 2000. AI maintains that these allegations are absolutely wrong because it offered <u>no</u> enhanced retirement benefits to either management or non-management network employees before the headcount losses occurred. According to AI, Cook County's allegations to the contrary have no basis in the record.

As AI's witness Hudzik explained, an unexpectedly high number of network employees retired in 1999 despite the fact that Ameritech Illinois' had proactively implemented measures which offset the impact of GATT-related changes for all network employees, both management and non-management, that would potentially be affected. Far from being an incentive to retire, as Mr. Hudzik explained, "the purpose of it was to get employees to change their minds and not retire." (Tr. 1953).

Ameritech Illinois maintains that it acted early and aggressively to maintain its network headcount. It renegotiated its collective bargaining agreements and offered additional benefits to non-management employees to avoid GATT-related headcount losses. Those changes were effective January 1, 1999. By mid-1999, when attrition proved greater than expected, Ameritech Illinois identified the problem and began hiring immediately.

By January 2000, long before service quality problems began, headcount was rising. And, in early 2000, still before service quality problems became apparent, Ameritech Illinois accelerated its hiring program. By the beginning of 2001, Ameritech Illinois had added 1468 network employees (over 17%), far more than restoring the 10% headcount loss that had occurred in 1999. AI notes that forecasts call for the Company to add another 900 network employees by the end of 2001. (Tr. 1958).

According to AI, the headcount increases have been accompanied by an enormous increase in network spending. Its network capital investments in Illinois have grown from $787 million in 1999, to $918 in 2000, to $1.043 million (estimated budget) for 2001. And, expenses have risen from $495 million in 1999, to $664 million in 2000, to nearly $800 million (estimated budget excluding network planning and engineering) in 2001.

AI claims that its performance has responded accordingly, since the second half of 2000, the average interval for installations requiring field visits fell, from 14 days to 5 days. Pending installation orders, requiring field visits, dropped from 48,506 to 22,411. In addition, OOS>24 was reduced to 4.3%, the average interval for all repairs fell from 54 hours to 21 hours, and the pending repair load shrunk from 19,501 cases to 9,323. In this same time period, customer complaints fell dramatically.

Certain of the GCI parties contend that business and repair office answering performance has also been deficient. But, AI maintains, there is little evidence to support this claim. It notes that, business and repair office answer times are “new” Part 730 standards in Illinois, made effective in October 2000. As a result, answer time data are limited, and the data available prior to October do not consistently measure performance for the same calling centers. While the GCI parties have characterized answer times as excessive, AI maintains that there is no evidence that actual consumers share that view. AI notes that, Staff’s review of customer complaints did not identify answer times as a problem. Similarly, customer survey data for February through August 2000 showed that customers rated the ease of getting their calls through to Ameritech Illinois’ business and repair offices in the neutral to satisfied range--from 64.6 to 75.3, where 54 is neutral and 84 is satisfied.

In any event, in response to the Commission’s new rules, Ameritech Illinois has hired additional employees in its business and repair offices. This, it claims, will assure staffing sufficient to comply with the 60-second answer time requirement in the Commission’s Part 730 rules. Here too AI claims, its recent performance reflects its additional hiring (and spending). As of the first of the year, business and repair office answering times averaged 60 and 31 seconds, respectively, for all calling centers.

AI notes that certain of the GCI parties i.e., CUB and the Attorney General contend that Ameritech Illinois "currently" queues customers from other states ahead of Illinois customers on calls to collection centers. Those claims are wrong, and Mr. Hudzik specifically explained, the queuing process described by the GCI was limited to a single call center for a short period of time prior to the effective date of the Commission's answer time standards. No such queuing of customers, AI maintains, has occurred since October 2000.

GCI/City's Position

GCI and City contend that the Company's performance, in key service quality areas, has been abysmal. The record, CUB claims, demonstrates a decline in Ameritech Illinois' service quality since the inception of alternative regulation and, more dramatically, since the Ameritech/SBC merger. CUB highlights the decline in AI's service quality as follows:

- Ameritech Illinois' performance in restoring service to customers within 24 hours of a reported outage (i.e., the OOS>24 measure) has declined dramatically. Its rate of failure in correcting "out of service" situations within 24 hours averaged about 14.1 percent between 1995 and 1998—over twice the average rate of failure in 1990 through 1994. While Ameritech Illinois reported some progress in 1999, its OOS>24 performance declined again in 2000, reaching 15.2 percent in August 2000. For the month of September 2000, AI reported an OOS>24 rate of 37%, more than seven times the allowed rate per 83 Ill. Admin. Code Part 730 and the existing plan.

- The number of lines that were "out of service" almost doubled between late 1999 and mid-2000.

- Since early 1999, the average number of days needed to install a new access line Plain Old Telephone Service ("POTS") (the POTS Mean Installation Interval measure)) has more than doubled for residential customers.

- Between December 1999 and June 2000, the speed at which customer calls are answered (the Average Speed of Answer measure) declined in the residential and repair call centers and the percent of customer calls answered in those call centers (as captured by the % Calls Answered measure) also declined.

- The average time to repair service, whether for all telecommunications service troubles as a whole (the Mean Time to Repair measure) or for POTS trouble on a stand-alone basis (the POTS Mean Time to Repair measure) has sharply increased since the SBC/Ameritech merger, with Ameritech Illinois reporting 77.7 hours to repair POTS in September 2000.

- Ameritech Illinois failed to keep an increasing percent of its POTS repair appointments (the POTS Missed Repair Appointments—Company Reasons measure) since 1998, missing 15.5% of its repair appointments in September 2000.

- Between 1999 and 2000, repair complaints increased by 71 percent, installation complaints increased by 190 percent, and construction and engineering complaints increased by 119 percent.

- By August 2000, the number of consumer complaints to Ameritech Illinois as tabulated through the executive appeals complaints process increased compared to 1999. Consumer complaint levels increased by 28 percent, 51 percent, 56 percent and 92 percent for maintenance, network, construction, and customer provisioning complaints, respectively.

- The percent of customers assigning Ameritech Illinois a low score of 0 to 5 (out of 10 points) for service quality in AI customer surveys increased by 20 percent from January 1999 to August 2000.

- Variations in state requirements have resulted in discriminatory treatment of Ameritech Illinois customers. Specifically, calls to Ameritech/SBC's collection offices by customers in other states are currently routed ahead of Illinois customer calls to meet other states' service quality standards.

- Ameritech Illinois' performance in answering calls from residential customers declined significantly between 1997 (the earliest year for which data is available) and mid-1999. The average speed at which Ameritech Illinois answers residential customer calls (the Average Speed of Answer—

> Residential Customer Call Centers measure) increased from 38.2 seconds in January 1997 to 413.1 seconds in June 1999. The percent of residential customer calls answered (the % Calls Answered—Residential Customer Call Centers measure) declined dramatically, from 93.2 percent in January 1997 to 59.5 percent in June 1999.

According to GCI, further indication of the decline in AI's service quality performance under the plan is found in the records of the ICC's Consumer Services Division ("CSD"), as discussed by Staff witness Jackson. In 1995, the first year of the plan, CSD received 14 complaints from AI customers regarding unsatisfactory performance of "scheduling or repair", and 20 complaints regarding unsatisfactory installation service. By 2000, those numbers had grown to 649 and 992 respectively, and excludes the 850 open service complaints that have not been closed and categorized. Ms. Jackson noted that specific complaints for poor performance by service technicians and customer service representatives have also increased. Ameritech Illinois' own data, GCI/City argue, also shows a pattern of serious degradation in critical service quality components.

GCI/City note Staff witness McClerren's assertion that the Staff has met with the Company for years to try to resolve the "out of service" problem, to no avail. His testimony shows that that in spite of the Commission's increased attention to the issue, the inclusion of a $30 million penalty in the SBC/Ameritech Merger Order for failing to meet the standard in calendar year 2000, and the Company's promises to the address the problem, AI *reduced* installation and repair technician staffing levels. Most of these technician headcount reductions occurred from August 1998 through January 2000, a period during which "increases in technician headcount were promised by the Company," according to McClerren.

The GCI/City also claim that AI's performance with respect to the "installation within 5 days" service quality measure has also been below par during the price cap plan, and particularly deficient in recent years. Mr. McClerren testified that the Company's installation performance has been unsatisfactory throughout the term of the plan. More specifically, the Company averaged more than five days for POTS installations throughout the January 1999 through September 2000 time frame, with the September 2000 time frames averaging more than 10 days.

According to GCI/City, AI also reported above-average delays in installation intervals for POTS service between June and August of 1999, at between 6.02 days and 6.41 days, when compared with average installation times of 5.86 days over the course of 1999. As noted above, installation intervals increased again during the August 2000 overtime restrictions.

Anecdotal evidence provided by AI's customers in a special meeting of the ICC and in complaints to CUB suggest that these numbers are deceivingly low given the fact that they do not capture Ameritech Illinois' performance for installation requests made in advance of a date certain. The anecdotal data regarding installation intervals for those customers suggests that they wait weeks or months for installation of service. (GCI Ex. 2.0 at 14.)

Despite AI's many service quality failings, the GCI/City assert that it has continued to cut costs by offering an early retirement package effective November 15, 2000 to management employees, including experienced field, area and general managers overseeing technicians in the field. And, it has also limited the amount of overtime each technician was allowed to work on at least two occasions in the last two years: June through August of 1999 and again in August of 2000. According to CUB, both of the limitations put on overtime coincided with sharp increases in the percentage of lines that were out of service for over 24 hours.

Deficient service quality not only affects AI's current customers, the GCI/City maintain, but also those few who have attempted to obtain service through a competitor. Most of the carriers attempting to compete with Ameritech Illinois are resellers that purchase the necessary equipment from AI leaving even those customers who have switched providers at the mercy of AI's failings.

City maintains that the Commission also should not limit its review to the eight service quality measures ordered in the 1994 Order because that would not give a full and accurate picture of the decline in service quality. While the Other Repair intervals of other Bell Operating Companies have remained relatively steady on average, the City claims that the Other Repair intervals not measured by the Plan experienced by Ameritech customers in Illinois have increased dramatically.

Finally, the GCI/City note that the record shows that AI's investment in outside plant has declined under the plan, which could explain the increased trouble and out-of-service conditions that occurred in recent years. AI's annual new investment in outside plant declined from about $35 per access line in the 1990-1991 timeframe to about $21 in 1994, increasing to about $29 in 1996 and declined to about $19.40 in 1999. Clearly, the Company's performance in critical service quality areas and the evidence of disinvestments in the POTS network point to the need for significant modifications to the service quality component of any new plan adopted in this proceeding.

All in all, GCI/City contend, the Company has utterly failed to "maintain the quality and availability of telecommunications services" under the existing price cap plan, as required by Section 13-506.1(b)(6) of the Act.

Staff's Position

Staff observes that original service quality standards were developed in the Alt Reg Order where the Commission stated that:

> Section 5/13-506.1(b)(6) requires the Commission to find that an alternative regulation plan will **maintain** the quality and availability of telecommunications services. [Emphasis added.]. . . . Therefore, we will adopt the Company's eight separate quality of service measures using the Company's average performance in 1990 and 1991 as performance benchmarks. Since the Company has exceeded the Commission's Part 730 rules, which are intended to be minimum standards which all LEC's must satisfy, it is necessary to establish these higher standards to safeguard against erosion of service quality. (Alt Reg Order, at 58.)

The Commission intended its actions to maintain service quality levels for the eight performance measures at the Company's actual performance in 1990 and 1991. Accordingly, Staff notes the Company's performance for those years was averaged to compute benchmark for seven of the measures. The eighth measure, % Out of Service > 24 Hours, was based on Code Part 730 since the Company performed below the minimum level required by Code Part 730.

Staff contends that the Company's reported service quality has been consistently substandard throughout the life of the plan. According to Staff, the Company missed the OOS>24 standard ten times in 1995, twelve times in 1996, twelve times in 1997, eleven times in 1998, three times in 1999, and four times through September 2000. Staff further states that in year 2000, the Company's OOS>24 performance was 14.4% in October, 5.6% in November, and is estimated to be 7.1% in December, 2000. Its year ending OOS>24 performance for calendar year 2000, Staff notes, is estimated to be 10.9%.

Staff's averaging of the Company's OOS>24 performance for the years 1990 to 1994 establishes Ameritech Illinois' "pre-plan" OOS>24 performance at 7.1%. Its averaging of the Company's performance for the years 1995 to 2000 shows AI OOS>24 performance to be at 12.0%, which would represent a deterioration of over 69%.

Staff also believes it instructive to consider the Company's OOS>24 performance for 1990-1991, since these years were used by the Commission to set the original eight benchmarks. When the Commission found that Ameritech Illinois' actual average performance had not met the Part 730 standard for OOS>24 for 1990 and 1991, it determined that the actual "average" could not be used, and mandated the use of the Part 730 standard for OOS>24. Assuming arguendo, that the Commission had agreed to simply "maintain" service quality for this standard and used the AI's average actual performance from years 1990 and 1991 to set the standard, the Company's performance during the life of the Alt Reg Plan still would have failed to meet the standard. The average for the Company's OOS>24 performance for the pre Plan years 1990 and 1991 provides a benchmark of 7.2%. Staff's averaging of the Company's

OOS>24 performance for the years 1995 to 2000 shows Ameritech Illinois' performance at 12.0%. This represents a deterioration of over 66% from the average of 1990 and 1991 levels, meaning that Ameritech has been unable to "maintain" service quality at a level that was already substandard.

Under either analysis, Staff claims, Ameritech Illinois' OOS>24 performance has deteriorated significantly over the course of the Plan. Further Staff notes it has met with Company representatives for years to try to resolve the out of service problem. Even with such increased Commission attention to the issue and the Company's promises to the contrary, the Company reduced installation and repair technician staffing levels. From August 1998 through January 2000, when most of the technician headcount decline occurred, there were several meetings between Staff and Company representatives where increases in manpower were promised by the Company.

Staff argues that, despite its meetings with the Company personnel, plan penalties, additional merger penalties and repeated commitments to improve performance, Ameritech Illinois would still experience the worst out of service problem in the history of the Plan. For the month of September 2000, Staff notes, the Company reported an out of service rate of 37.0%. This, it claims, exceeds the allowed rate per Code Part 730 and the current Alternative Regulation Plan by a factor of seven.

Staff maintains that the Company's installation performance has also been unsatisfactory. The Company reports that it missed the "installation performance within 5 days" standard for four months in 1996 and one month in 1999. In addition, the Company had problems reporting information accurately, i.e. the installation performance for calendar year 1999 was restated in June 2000. And, Staff believes the Company's chosen definition of installation performance is inappropriate and thus results in an understatement of service quality performance failures.

Staff claims that Ameritech's failures are further evidenced by the steady and drastic increase in the number of service quality complaints received by the Illinois Commerce Commission's Consumer Services Division ("CSD") in the year 2000. Reports of complaints made directly to Ameritech also depict a dramatic increase in complaints through the life of the Plan. It is unrefutable Staff claims, that consumers have suffered from long delays in obtaining repair service and installation of service, and from significant of scheduling problems experienced at the hands of Ameritech representatives.

In reporting on performance, Staff also believes the Company has applied an inappropriate definition of "installation" performance for that measure. It notes that Part 730.540(a), which is the foundation for the performance benchmarks in the Alternative Regulation Plan, states the following about installation requests:

> The local exchange carrier shall complete 90% of its regular

service installations within five working days after the receipt of the application, unless a later date is requested by the applicant.

Staff believes that the term “regular service installations” should not be construed to mean vertical services and should relate only to the provisioning of regular telephone service, i.e., dial tone. Vertical features, such as Caller ID, Three-way Calling or Call Forwarding, are supplemental or added features to dial tone service and Staff considers requests for such services to be “change” orders. So too, Staff claims, the Company’s tariffs show that vertical services are “optional” or “custom” services and not regular service. (Tr. 1804-1807.)

Yet, Staff contends, somewhere between the advent of vertical services and today, the Company alone arbitrarily decided to add vertical services to their reporting of “regular service installations” performance data to this Commission. None of the other Illinois local exchange companies which Staff contacted include vertical features in their installation data compiled and reported to the Illinois Commerce Commission.

Staff notes that the hearing testimony of Ameritech witness Hudzik shows that the success rate for meeting the Installation within five days requirement for vertical services is probably “99 percent,” and, perhaps higher. (Tr. 1935.) With vertical services removed from installation figures, Ameritech’s success rate in 1999 was “between 88 and 90 percent.” (Tr. 1938.) For the period of June, July and August, 2000, AI’s rate for meeting the installation requirement, including orders for vertical services, was between “96.5 and 98.3” percent. With vertical service orders excluded, the Company’s performance “would have been in the 70 percent range.” (Tr. 1939). This evidence makes clear that Ameritech’s actual performance in relation to this standard has been obscured by the inclusion of vertical services statistics.

Staff witness McClerren noted that there is a rulemaking proceeding underway to addressing Part 730, Standards of Service For Local Exchange Telecommunications Carriers. Among other things, Staff intends to review the definitions of measurements to ascertain that all parties are measuring performance in the same manner. In that proceeding, Staff claims, it will recommend that vertical services should not be included in the installation calculation, and also to have additional lines treated as regular installations. Staff believes, however, that the definitional changes it is proposing should not be viewed as an admission that vertical services should have been included in the “regular service installation” calculation under the current language of Part 730.

Staff notes that the Company barely made the “Operator Speed of Answer - Intercept” measure for the year 1995, failing the standard in four separate months. It also failed the same standard, on a "monthly" basis, once in 1996 and three times in 1997. The “Trouble Reports Per 100 Lines” measure was missed twice in 1995, four times in 1996, and once in 1997, according to Staff’s monthly assessment.

Overall, the Plan has contributed to Ameritech Illinois' failure on OOS>24, Staff claims, because it has been less costly for Ameritech Illinois to incur and pay the penalty (approximately $4 million) than to pay the expenses required to upgrade performance to meet the standard (approximately $30 million). This concept Staff claims was at the core of its testimony in the SBC/AI merger docket and resulted in Condition 23 of the Order requiring a $30 million penalty if the Company failed to meet the OOS>24 standard.

Staff notes that Ameritech has acknowledged that it has missed the OOS>24 standard in 2000, and is in the process of distributing the $30 million worth of credits to customers.

Commission Analysis and Conclusion

Both the GCI/City and Staff conclude that the quality of service has seriously deteriorated under the Plan. They each produce a number of different analyses of the Company's performance under the Plan and suggest a number of different reasons for the decline on service.

We note that a number of these analyses are focused exclusively on the OOS> measure or single out monthly performance instead of benchmark, i.e., annual performance. In a similar view, we are provided with a list of failures again mostly concerning OOS>24 that occurred in year 2000. While valuable to some degree, this does not provide a full account and complete picture.

In light of all the recent service quality problems, it is difficult to remain objective and impartial. This, however, the Commission must do. It must put aside its dissatisfaction and stresses over the past year and maintain its integrity by examining the evidence for not only year 2000 but also for all the preceding years operation of the Plan. It must examine the evidence on all of the measures, and not only those two that appear most troublesome.

In doing so, we find that AI has provided acceptable service on most of the measures we set out in the Plan. We agree with Staff, however, that reasonable service in one area will not excuse poor or substandard performance in other areas. The OOS>24 hours measure has been singled out, and properly so, since it is a major component of service. Indeed, we recall the City's argument that when a customer cannot obtain telephone service because of a outage, no other performance measures really matter. To be sure, OOS>24 hours compliance was a matter of great concern when we fashioned the Order issued in Docket 98-0555. Yet, despite our increased attention to this matter AI again failed in its performance.

We cannot confidently identify from the record the single, definitive source of the Company's performance problems. As best we can determine, the manpower shortages due to unexpected retirements appears to coincide with the worst of the infractions and it is inconceivable that AI would purposefully take actions that degrade service quality at a time so close to this review proceeding. Regardless of the cause of service quality degradation, if we continue with the Plan, AI is put on notice that its service obligations must be the Company's top priority and that it must take whatever action is necessary to ensure compliance with those obligations. While AI appears to be moving in the right direction, the record we review for this section of the proceeding compels us to find that the Plan has failed to met the statutory service quality requirements.

We observe in hindsight, that the Plan itself, by foregoing a positive adjustment, may not have provided the correct incentive for the Company. We will take the lessons learned and apply them in another section of this Order.

10. The Public Interest

Authority: Sections 13.506.1(b)(1); 13.506.1(b)(4) and Alt Reg Order.

Section 13-506.1(b)(1) requires that any alternative regulation plan serve the public interest and subsection (b)(4) requires that it be a more appropriate form of regulation, based on the Commission's overall consideration of the policy goals set forth in Sections 13-103 and 13-506.1(a). The Commission concluded in 1994 that these standards were cumulative of all the Section 13-506.1 requirements and policy goals and could be resolved affirmatively if its conclusions on the other statutory requirements were positive. (Alt Reg Order at 188, 191).

GCI's Position

The GCI maintain that the review of the Plan operations demonstrates that the Commission and the legislative requirements and goals have only been partially met. They believe that AI's non-competitive and competitive rates are not just and reasonable; that services classified as competitive have seen rates increase; that service quality has deteriorated; that only minor innovations have been identified; that the expectation of effective, price constraining competition has not been fulfilled; that regulatory delay and costs are still prevalent, that the service basket structure has been manipulated to the detriment of consumers using the most inelastic and essential services; that AI has earned profits at a level that can only be achieved in a monopoly environment; and that POTS consumers have received only a marginal portion of the rate reductions required by the price cap plan (primarily through volume discounts on usage) or have actually paid increased rates as a result of subscribing to AI's Simplifive calling plan which was erroneously promoted as a lower priced plan.

According to GCI/City rate reinitialization is necessary to bring rates back to just and reasonable levels, and changes to the plan are necessary to bring it into compliance with the law and the Commission's goals. If the necessary changes are not made, they contend that AI should be returned to rate of return regulation.

Staff Position

Staff notes that it has been involved with the development and implementation of the plan from its inception. In Staff's opinion, the Plan has functioned reasonably well, with certain exceptions. In Staff's view, there is no persuasive evidence to indicate that the rates produced by the Plan for non-competitive services are not just and reasonable. Further, the Plan has generally reduced regulatory burdens and the need for regulatory oversight to some degree and has provided Ameritech additional pricing flexibility for certain services.

On balance, Staff notes several defects in the Plan have become apparent over its life. The most significant, service quality, has deteriorated markedly as per the Plan's indices. Further, Ameritech has structured its annual price cap filings to reduce consumer benefits under the Plan.

According to Staff, Ameritech has also prematurely and inappropriately reclassified a number of services as competitive, thereby removing them from the aegis of the Plan. While not directly at issue in this proceeding, Staff believes that this matter unquestionably bears upon the overall effectiveness of the Plan, and in its view, has compromised the efficacy of the Plan by reducing the benefits that consumers might otherwise have realized.

Staff believes that the first and second defects it has identified must be addressed in this proceeding if the Plan is to be compliant with the public interest. If the appropriate adjustments are made to correct these defects, Staff recommends that the Plan be extended.

Staff, however, does not recommend that that rates be reinitialized directly as a result of Ameritech's earnings achieved under the plan. Nor is it Staff's recommendation that Ameritech be returned to rate-of-return regulation.

Commission Analysis and Conclusion

As intended, we have examined the Plan's operations under each of the underlying particulars which now converge to bring the public interest question squarely into view. The issue before us now is whether the Plan should be continued with any modifications, whether a new and different plan should be considered, or whether AI should return to rate of return regulation. It is crucial at this moment, that we step back to get a full and complete picture before making the ultimate assessment.

As we see it, the Plan, while not perfect, has worked reasonably well during its initial phase. No regulatory scheme that we have ever examined, however, is perfect in either concept or in execution. As with any new undertaking there are inevitable growing pains in the process and hindsight is both a blessing and a curse.

Taking an overall view of the Plan we see that a number of significant benefits were realized : rate reductions for non-competitive service customers went into effect each year; the Company was incented to and did invest in its network; millions were spent to facilitate competitors' entry; the Company learned to become more business oriented and prepare itself for competition; and given the freedom to manage its capital recovery shortfall the Company addressed the problem, and regulatory burdens were reduced.

On balance, the Company's service quality performance has not been up to standard and gives us great concern. The annual filings, Staff claims, have given AI too many of the benefits. These problems although weighty, do not overwhelmingly direct a finding that the Plan is not in the public interest or that going back to rate of return regulation is the best option.

It sometimes difficult to ferret out the shortcomings attributable to the Plan from those which follow from outside circumstances. It is also easy to confuse the two. The fact that competition has not developed as fully as anticipated is not in our view a fault of the Plan. To be sure, competition is one way to constrain prices. The mechanism set in the Plan is another. In other words, while competition has not grown substantially, neither has the Company been set free to do what it will. For example, in instances where its reclassification of services was questionable, there was, and is, a means to correct any overreaching. And, that very type of proceeding is currently underway.

The public interest is a variable concept. It expands and contracts with the times and with the circumstances. Many aspects of the Plans are quite notable while others can well bear criticism. We note, however, that Staff, GCI and others do not stop and rest on their criticisms of the Plan, but have each developed detailed and comprehensive proposals for the future. For example, on the critical issue of service quality, we are presented with a number of options to ensure that performance at acceptable levels will be maintained. All of this tells us that the public interest can be fully restored

Staff does not recommend a return to rate of return regulation. To the contrary, Staff recommends that we modify several aspects of the existing Plan to ensure that it prospectively satisfies statutory requirements in areas where there are deficiencies. Staff notes that ROR regulation has a number of well-documented problems stemming from its diminished incentives for cost efficiency and technological innovation. An even greater handicap is that it cannot be readily adjusted to provide pricing flexibility when warranted. AI also contends that ROR regulation is outdated, ill-suited for responding to changing conditions and markets, and substantially increases regulatory burdens.

There were a number of considerations which the Commission took into account when it adopted alternative regulation for the Company. Those same considerations compel us to conclude, here and now, that alternative regulation is more responsive to meet the challenges of a ever-changing and rapidly changing telecommunications market. The "cost plus" nature of rate of return regulation did not deliver any brilliant cost and price performance. A return to ROR regulation today is simply not a viable alternative given the current telecommunications environment. It cannot be denied that technological and market changes are changing the entire telecommunications industry and over the next few years meaningful competition, in one form or another, will likely arise in most of AI's markets.

Regardless of what their respective concerns may be, and putting aside the merit of those concerns, no party has taken the position that the Plan's failures are unfixable.
In each of their respective briefs, the Staff, the GCI/City, AI and others set out a variety of modifications to the existing Plan which they believe will satisfy the statutory requirements including the public interest. Implicit in these proposals is the recognition that alternative regulation is the better choice for AI.

Based on the Commission's overall consideration of the policy goals and requirements set forth in Section 13-506.1 and the whole of the evidence in this proceeding, we find that the Plan constitutes a more appropriate form of regulation which can and will be modified to serve the public interest. Hence, we move forward.

IV. RATE RE-BALANCING

AI's Position

In its rate re-balancing proposal, AI proposes to increase the monthly charge for residence network access lines by $2 per month across all access areas, while reducing other service rates to make the plan revenue neutral. The new residence access line charges, including the end user common line charge ("EUCL"), would be $8.90 in access area A, $11.88 in access area B and $15.35 in access area C. AI asserts that there has been no increase in network access line rates since 1990. Even with the proposed $2 increase in effect, the network access lines will have increased less than the inflation rate. Thus, AI asserts, even after the increase, the real costs of residence access lines would be lower than it was in 1990. AI projects the total revenue increase resulting from the residence network access line increase would equal $84.1 million.

AI has requested the increases to bring rates more into line with costs and to narrow the difference between residence and business access line prices. At current rates, AI claims its residence access lines are priced below LRSIC in access area B and C. Although current rates cover LRSIC in access area A, AI asserts that when shared costs and non–recurring costs are included, that rate is also below cost.

Moreover, AI asserts that LRSIC, as calculated under the Commission's Cost of Service Rule (the "Rule"), 83 Ill. Admin. Code Part 791, understates the incremental costs of network access lines. Section 791.70(d) requires that LRSIC be calculated based upon the assumption that the entire useable capacity of network facilities is used to provide service. "Usable Capacity" is the maximum physical capacity, less capacity required for maintenance, testing or administration. 791.20(n). In the real world, facilities are almost never operated at their usable capacity for a variety of necessary reasons. Therefore, more facilities are required to meet the demand for residence access lines than are included in the cost study. The "spare capacity" costs for these necessary, additional facilities are treated as common costs to be recovered from all services when, in reality, they should be considered part of the LRSIC costs of access lines. Spare capacity costs for residence network access lines are shown in AI Ex. 10.1, Schedule 9 (rev.) and are significant. If spare capacity costs were included, the LRSIC of access lines, on average, would increase by 80.2%.

When LRSICs (as computed under the Rule) are considered in conjunction with shared, non-recurring and spare capacity costs, access line prices are significantly below costs in all access areas, even if those services are not asked to contribute to the recovery of common costs. However, the Commission has recognized that individual services should make a reasonable contribution toward recovery of common costs in both the TELRIC proceedings and Phase II of Access Charge reform proceedings. Similarly, the FCC required LECs nationwide to develop forward-looking economic costs of service ("FLECs") that included an allocation of common overheads. These costs will be used by the FCC to determine eligibility for federal high cost funds. The Commission approved AI's FLEC methodology in Docket 97-0515.

In AI's opinion the under-pricing of access lines has adverse consequences for both customers and competitors. Competitors have shared costs and spare capacity costs too. When residence access lines are priced so low that they do not recover costs, or at least a substantial portion of them, AI claims its competitors are deterred from offering residence access line services which result in a lack of infrastructure investment. For consumers, AI claims low prices stimulate inefficient and excessive demand, which the Company is reluctant to build new facilities to satisfy because the service is unprofitable. Consequently, AI believes efficient consumption of services such as usage and vertical features is discouraged because these services must be priced too high in relation to their costs in order to make up for the shortfall in residence access line revenues.

To offset the increase in rates for residence network access lines, AI proposes to reduce one-time residence service ordering and installation charges by $21.6 million. Further, AI is offering to reduce Band B additional minute charges by approximately 12.7 million based upon the Company's perception that consumer would like to see the Band B rate structure move in the direction of the Band A per call rate structure. AI also proposes to reduce pay per use charges for three calling features: automatic callback, repeat dialing and three way calling, by about $5.1 million. Finally, AI has already reduced carrier access charges by $33.3 million pursuant to Commission Order in Dockets 97-0601, 97-0602, and 97-0516 (consol.) and expects further reductions of $10.5 million for a total overall carrier access reduction of $43.8 million.

Staff's Position

Staff believes AI's re-balancing proposal has numerous defects and recommends the Commission reject the proposal. First, Staff claims that AI is understating the amount of revenue collected from the provision of network access line services. Particularly, Staff asserts the understatement of revenue occurs from AI's estimate of revenues it receives from EUCL charge. As such, Staff concludes, even using AI's LFAM cost studies, AI's proposal cannot be justified.

Second, Staff contends that AI's LRSIC for network access line services show what the Company concedes are "substantially" increased compared to those the Company filed in its 2000 Aggregate Revenue Test filing. Based upon AI's new model, LRSIC for network access line services increased from 34% to 53%, depending on the Access Area. Staff assets that without the above mentioned increases, revenues from network access line services would exceed LRSIC in all access areas.

Staff rejects AI's new model, the Loop Facility Analysis Model ("LFAM") and urges the Commission to do the same. Staff notes with skepticism that AI's new LFAM shows costs increasing dramatically while at the same time industry costs are declining. Staff points out that this Commission has never approved a cost study generated by, or costs derived from the LFAM model. Staff is not persuaded by AI's argument that its new model is able to identify and recover costs that prior models failed to identify and recover. Staff rejects AI's LFAM model for failing to conform with part 791 of the Code, specifically: the model uses futuristic network rather than planned network, use of incorrect fill factors, and it failure to reflect the demand for the entire service. Further Staff detected what it views as programming flaws. Staff contends that AI's interface of fiber vs. Copper break length assumption are inaccurate. Additionally, material costs contained within the model fail to account for any merger related savings.

Because of an uncertain demand effects, Staff, contends that AI's proposal is not revenue neutral. Staff claims that AI's proposal would actually result in revenue increases for AI. Staff's difficulty with the proposal is that AI proposes increases to services with relatively inelastic demands and decreases to services with relatively elastic demands.

Next Staff rejects AI's use of access charge reductions ordered in Dockets 97-0601, 97-0602, and 97-0516 (consol.) to offset rate increases. Staff claims that these specific rate reductions are not an appropriate way to offset any rate increases to network access line charges. Staff Initial Brief at 126. While Staff acknowledges generally that certain price reductions could be made if network access line rates were below LRSIC, such reductions must come from within the Plan itself. Staff contends that AI seeks to do is to improperly offset price increases with price reductions which were required outside of the Plan.

As a general proposition, Staff does agree that to the extent that revenues generated from providing network access line revenues are below LRSIC, rate re-balancing in some form might be appropriate. Only to the extent that AI could prove that a rate is below LRSIC would Staff consider a corresponding rate increase.

Staff then seeks to rebut AI argument relative to contribution for shared and common costs. Staff asserts that it is not necessary for every service to contribute toward shared and common services. Staff offers its own proposal should the Commission agree that residence network access line rates are below LRSIC. Staff suggests that there be a reduction in Band A usage rates. Staff states that its proposal would pass on benefits to nearly all customers as opposed to AI's rate reductions to optional and in its view unnecessary services. Further, Staff notes its proposal will negate or diminish the effect of increase costs on those consumers who can least afford an increase.

Staff concludes however, that based upon the LRSIC used in AI's year 2000 Aggregate Revenue Test, revenues for residence network access lines exceed LRSIC in all access areas. Therefore, Staff surmises, AI's rate re-balancing proposal must be rejected.

DOD's Position

The DOD supports AI's rate re-balancing proposal. DOD states that the proposal will however create a net increase in revenue for AI. DOD contends that it is beneficial to align rates with costs as the telecommunication industry transitions from a monopoly market to a competitive environment. DOD argues that network access line rates have been underpriced relative to it costs. DOD/FEA also contends that the AI proposal will reduce rates for certain services that have been priced above costs.

DOD proposes modifications to AI's rate re-balancing proposal. To address the concerns of Intervenors relative to issue of Universal Services, DOD/FEA suggests that those customers would otherwise be eligible for lifeline services be exempt from the rate increase proposed by AI. Further, DOD/FEA recommends that IXCs provide proof to the Commission that reductions in carrier access charges are flowed through to ratepayers. Next, DOD/FEA proposes that the Commission direct AI to reduce all monthly network access line charges, both residence and business, by an amount that equates on a revenue basis to the reduction in access charges that were not previously passed through to consumers. Additional consumer protection is necessary DOD/FEA argues, because historically, market forces have not lead to a flow through of rate reductions to consumers.

City/CUB Position

CUB, AG, and County ultimately adopt the arguments made by City. City also urges the Commission reject AI's rate re-balancing proposal. First, as a Universal Service policy consideration, AI's proposed increase may result in forcing low income customers to drop off the network. On balance, City claims that customers' overall bills will increase rather than remain neutral.

Like Staff, City is skeptical of AI's new LFAM model results given that AI had just a few months prior filed with the Commission its Annual Revenue Test report which indicated substantially reduced costs. City addresses what it views as flaws of AI's LFAM model. First the LFAM failed to use "Least Cost Currently Available" technology. Next, City assets that AI improperly included "common" costs of a switch in the port cost. City charges that AI improperly double recovered the costs of installing the network interface device. The AI LFAM failed to address what the City calls a line mix assumption. What the City suggest is that AI take into consideration the different costs associated with the costs per line of installing a new switch versus the costs of adding lines to an existing switch. City asserts that AI's data shows they considered the higher costs per line for new switches disproportionately which skews costs upward. City claims that AI's use of the "revenue ready" fee in the network access line LRSIC is improper as said fee can be attributable to several other services, not just network access lines. Further, City claims it is inappropriate to include the costs of receiving and processing payments for several services, as a costs attributable to network access line rates. Like the revenue ready fee above, City asserts the cost for receiving and processing payments should at the very least be spread across LRSIC for several services. City also rejects AI's use of "Cost of Capital" in its LFAM. Lastly, City contends that AI's LFAM considers an inflated "net investment."

City also rejects AI's attempts to include additional costs to network access line LRSIC. City claims the addition of "spare capacity" and advertising costs artificially inflates network access line LRSIC. City argues that the Commission cost of service rules require that LRSIC include only "usable capacity and not the additional spare capacity. Lastly, City asserts it is improper to assign 100% of advertising and related costs solely to network access lines.

City concludes that AI's rate re-balancing proposal should be rejected as it is not justified on a cost basis or any purported policy reason offered by AI. Like Staff, City asserts the year 2000 Aggregate Revenue Test report filed on March 31, 2000, indicates that AI's rates are already in excess of costs. Similarly, City objects to AI's use of optional vertical services as an offset to an increase in network access line rate.

AT&T's Position

In response to Staff's proposal to offset increase for network access line rate with a corresponding decrease in Band A usage rates, AT&T cautions the Commission not adopt any modification which would reduce rates simply to balance revenues rather than reduce rates based upon costs. Further, AT&T rejects AI's assertion that the

Commission concluded in its Phase II Order that AI was entitled to revenue neutrality to compensate it for the reduction required in said order. Rather, AT&T asserts, the Commission concluded that AI was not entitled to revenue neutrality as a matter of right. However, AT&T acknowledges that the Commission would allow AI to seek out whatever mechanisms were available to it to attempt to recoup any lost access revenues. Finally, AT&T argues that should the Commission approve AI re-balancing proposal, AI must implement its estimated additional $10.5 million in network access line reductions at the same time any authorized rate increase is to take effect.

AI's Response

AI responds to many of the concerns of Staff, City/GCI and DOD. Generally AI argues that its new LFAM model is an improvement over the model previously use. AI's asserts its new model results in cost studies which are more accurate than that performed for the 2000 Aggregate Revenue Test. With respect to the arguments of Staff, AI states that it has met its burden and shown that current network access line rates do not cover LRSICs. AI relies upon it updated costs model, the LFAM. AI states that it did not understates access line revenues. Also, AI amended its revenue analysis to take into consideration Staff's concern over account demand changes. Lastly, AI again asserts that it perfectly acceptable within the Alternative Regulation Plan to offset a portion of the proposed network access line rate increases with the carrier access charge reduction required in Dockets 97-0601/97-0602. In response to Staff's alternative offset proposal, reduction of Band A rates, AI argues that based upon current usage, further reduction is Band A rates will cause costs for said service to increase above LRSIC.

With respect to the arguments of City, AI states that its costs study is accurate and reliable and supports increasing access line rates. Additionally, AI asserts that other services may be currently priced above cost to make up for the shortfall which exists because network access line rates are priced below cost. Lastly, City's argument that basic residential services rates cannot be increased because of the moratorium against said increases imposed in the Order, must be rejected. AI asserts, the moratorium was for a specific period of time, five years. Given that the five year period has elapsed, AI contends it may properly seek rate increases for residential services.

AI rejects DOD's proposal to exempt certain customers from its proposed rate increase. AI asserts that the simultaneous reductions of rates to other services will offset its proposed rate increase. Further, that because services associated with new service will be see rate reductions, AI opines that telecommunication services will become more economically accessible.

Commission Analysis and Conclusion

The Commission concludes that the rate re-balancing proposal of AI must be rejected in its entirety at this time. Despite AI's protestations to the contrary, Staff and City fully set forth several deficiencies with the LFAM. Particularly troubling is the LFAM's lack of compliance with part 791 of the Administrative Code. Also troubling is the apparent programming flaws detected by Staff and City. We note that City lists no less than seven deficiencies with AI's LFAM.

What is telling about the new model's reliability or lack thereof, is the significant change in costs resulting in the use of the LFAM model from the use of the 2000 Aggregate Revenue Test. Both tests were done within just a few months of one another. AI would have the Commission believe that it's model used in the 2000 Aggregate Revenue Test was so deficient that it failed to capture up to 1/3rd of the total actual costs for network access lines. To say the least, the Commission is skeptical of the LFAM's ability to find never before found costs. Further, the Commission rejects the LFAM model to the extent that it fails to comply with requirements of Part 791. Staff correctly points out that this Commission has never approved a cost study generated by, or costs derived from the LFAM model nor do we choose to today. Ultimately, AI has failed to meet is burden in convincing the Commission that its costs for network access lines are above LRSIC. For that reason, the Commission rejects AI's rate re-balancing proposal.

V. GOING FORWARD

A. The Existing Components of the Formula.

The alternative form of regulation ties rates for noncompetitive services to an index and, thereby supplants AI's typical rate case with a more streamlined process with which price changes can be approved. The process consists of an annual filing made by AI and requires subsequent approval by the Commission of the proposed price cap index, to be effective on July 1 of the year of the filing. Under the Plan the PCI must be recalculated once each year. The PCI can be generally described as: PCI = Inflation factor minus the "X" factor (4.3%) for a productivity offset, minus 0.25% for each missed service quality benchmark, +/- any Commission-approved "Z" (exogenous change) factor.

Terms used in the PCI are generally described as follows:

> ***Inflation Factor:*** inflation is represented by Gross Domestic Product Price Index, ("GDPPI") which measures economy wide inflation for all goods and services;
>
> ***X factor:*** the X factor represents the extent to which AI (or the telecommunication industry in general) experiences productivity growth which exceeds that of the overall

economy (economy-wide productivity gains are already reflected in GDPPI) and any consumer dividend which the Commission may include;

Z factor: the Z factor captures "Exogenous changes," which are externally driven costs or revenue changes which impact AI uniquely or disproportionately reflective to the overall economy; and

Service Quality Factor: the service quality factor established benchmarks for service and imposes penalties if service quality declines.

More precisely the PCI formula is as follows:

PCI_t = PCI_{t-1} [1+ (% change in the GDPPI)/100-.043 +/- Z - Q]
where:

PCI_t	= price cap index for current year,
PCI_{t-1}	= price cap index for previous year,
GDPPI	= Gross Domestic Product Price Index,
Z	= exogenous change factor, and
Q	= quality of service component, which is negative.

Additionally, pursuant to the Plan, most of AI's noncompetitive services have been separated and placed into four distinct customer groups or service baskets. They are as follows: 1) Residential Basket, 2) Business Basket, 3) Carrier Access Basket and 4) Other Services Basket. The prices for the services within each of these baskets are allowed to fluctuate over time such that each basket's Actual Price Index ("API") never exceeds the PCI. The requirement that API for the baskets are less than PCI has placed the emphasis of AI's annual filings on the calculation of the PCI and the justification of each of its inputs.

Each basket's API is a reflection of the basket's average price once demand and any proposed tariff changes are properly accounted for. The API may change at any time during the year when price changes are made. (Order, Appendix A at 3). The API for an individual basket is calculated as follows:

$$API_t = API_{t-1} * \sum_{i=1}^{n} v_i \frac{P_i(t)}{P_i(t-1)}$$

where:

API_t	= actual price index for the current year,
API_{t-1}	= actual price index for the previous year,
i	= rate element i,
$P_i(t)$	= proposed price for the i_{th} element,
$P_i(t-1)$	= current price for i_{th} element, and
v_i	= revenue weight for i_{th} element.

The Commission has established a very specific set of filing requirements which the product thereof the Commission can use to determine whether it should approve AI's annual rate filings with or without modifications. In its Order, the Commission stated:

Illinois Bell shall be required to make an annual rate filing no later than April 1 of each year of the plan after 1994. At that time, Illinois Bell shall provide the following information:

(a) the price cap index for the following 12-month period (July to June), with supporting data showing the GDPPI for the previous calendar year and the percent GDPPI change for that 12-month period;

(b) the actual price index ("API") for each service basket, including the effects of proposed rate changes under the price cap index for the following 12-month period (July to June) and adjustments for new services added, existing services withdrawn, and services reclassified as competitive or noncompetitive;

(c) tariff pages to reflect revised rates;

(d) supporting documentation demonstrating that any proposed rate changes are consistent with the requirements of the price index mechanism;

(e) a demonstration that Illinois Bell would be in compliance with Sections 13-507 and 13-505.1 of the Act if the proposed rate changes went into effect;

(f) an identification of any changes to the GDPPI weights and an assessment of the effects of such changes, and any necessary modifications to the PCI;

(g) the current data showing the calculation of Z for the previous calendar year, with the events causing Z to change identified and described;

(h) the current data showing the calculation of Q for the previous calendar year, with the events causing Q to change identified and described.

(Order at 92). The Order further provided that "Staff and all of the interested parties will have an opportunity to file written comments in response to each annual filing and the Company will have an opportunity to file reply comments." (Id. at 93).

B. Proposed Modifications to the Price Cap Index.

1. Measure of Inflation

One component of the PCI is the Inflation factor which is derived by using GDPPI. The GDPPI is used to measure the annual economy wide inflationary change that has occurred in a given time period. GDPPI is published by the Bureau of Economic Analysis, U.S. Department of Commerce ("BEA"). At the time of it's Order, a fixed weight version of GDPPI was the accepted and published output measure of inflation for the economy.

Since the entry of the Order, a "chain weighted" GDPPI has replaced the fixed weight GDPPI as the most commonly used inflation measure in the economy. Staff, as well as most every party, acknowledges that the methodology used to compute the chain weighted GDPPI is closer to the methodology used to compute AI's input prices. The methodologies used to compute the chain weighted GDPPI and AI's input prices allow for changes in the composition of output or input, whereas the methodology used compute fixed weight GDPPI does not. The parties agree that it is more proper to use the chained weighted GDPPI in the future as the inflation index.

The Commission concludes the use of a chain weighted GDPPI shall be substituted for the fixed-weight version in the price index on a going forward basis.

2. X Factor

Under the Plan, the "X" Factor in the price cap formula consisted of three elements: productivity differential, input price differential, and consumer dividend. The productivity differential measures the difference between telecommunications total factor productivity gains and overall economy total factor productivity gains. The input price differential measures the difference between telecommunications input prices and economy wide input prices; The third element of the X factor, the consumer dividend, is a judgmental factor imposed by the Commission based upon its expectations regarding gains that arise from technological and or regulatory change that the Commission anticipates. Under the Plan, the productivity differential was set at 1.3%, the input price differential was set at 2.0% and the consumer dividend was set at 1.0%. (Order at 38.)

Under the Plan the productivity and input price differentials were based upon AI's productivity and input price performance versus the economy as a whole, as opposed to industry productivity and input price data. Industry productivity and input price data was not yet available. Staff proposes that both productivity and input price differential be based on industry rather than AI specific data. AI, concurs.

a. Productivity Differential & Input Price Differential

AI and Staff's Position

AI sponsored the testimony of Mark E. Meitzen in support of its proposed productivity differential. Meitzen provided an analysis of the local exchange industry's total factor productivity ("TFP"). Meitzen's analysis used the Total Factor Productivity Review Plan ("TFPRP") which was developed by the United States Telecom Association ("USTA"). Meitzen concluded that 3.3% is appropriate for the productivity differential and input price differential. Similarly, Staff relies upon the USTA productivity study and also recommends adopting the 3.3% figure for productivity differential and input price differential. (Staff Initial Brief at 36.)

AI therefore proposes a productivity differential and input differential of 3.3%, with no consumer dividend for an overall X factor of 3.3%. Staff recommends a productivity differential and input differential of 3.3% plus a 1% consumer dividend for an overall X factor of 4.3%.

GCI/City's Position

Upon a review of the initial briefs of City, AG, County, and CUB, it appears as though they have taken a consistent view with respect to the issue of the X factor. Each of the above intevenors filed separate briefs relative to the issue of the X factor but filed a joint reply brief on this as well as other issues. City/GCI maintain that an overall X factor 4.3 is too low. City and GCI recommend an overall X factor of 6.5% which would in effect incorporate a productivity differential, input price differential, and a consumer dividend. GCI bases it's recommendation of a 6.5 % X factor on the proposal made by SBC, Bell Atlantic, Bell South, and GTE in the CALLS Proposal.

CUB acknowledges that one of the most important elements of a price cap formula is the establishment of an appropriate productivity offset. In a competitive market companies have an incentive to improve productivity and cut costs in order to increase profits. CUB suggests that in theory competition will cause improved productivity and resulting lower prices to customers. The goal of a productivity offset in a price cap formula, CUB asserts, is to reflect the characteristics of a competitive market.

CUB is critical of AI and Staff's reliance upon AI's Total Factor Productivity ("TFP") study. First CUB contends it is no longer appropriate to use company specific data as a basis for calculating TFP. CUB notes that at the federal level, in the FCC price cap formula, industry results are used rather than those of a specific company.

Secondly, the X factor under the current plan was insufficient to assure that consumers realized their share of efficiency gains. CUB makes this assertion because of what it deems to be AI's staggering earning levels. Further, CUB is critical of relying upon the USTA TFP. CUB states that the FCC has never used the USTA study for purposes of creating an X factor. CUB witness Selwyn finds fault in the USTA TFP study for using deflated revenues to measure local output. Additionally CUB argues the USTA study's use of economy wide cost of capital data as a proxy for local exchange carrier costs of capital essentially creates a cross subsidy flow from noncompetitive services.

AI and Staff's Response

Both AI and Staff responded to CUB criticisms of AI's TFP. AI witness Meitzen, and Staff witness Staranczak explained that the deflated revenue approach is a well known and widely accepted method for measuring output. Meitzen notes that the Bureau of Labor Statistics uses the deflated revenue approach to construct its output index for the telecommunications industry. Meitzen also points out that the deflated revenue approach was used in the original alternative regulation plan.

City, in its initial brief, incorporates the position of AG. AG ultimately concludes that the goal of the X factor is to maintain AI's rates and earnings at reasonable levels. AG does not criticize, as CUG does, AI and Staff's reliance upon AI's TFP as a predicate to rejecting the 4.3% X factor. AG does however reject the 4.3% X factor as being too low. Under the current plan AG contends the 4.3 X factor has failed to curb what it deems as AI's excessive earnings. Like CUB, City and AG recommend the use of a 6.5% X factor.

County also calls for the adoption of a 6.5% X factor as used by the FCC for intrastate services. Like AG and City, County does not specifically criticize AI's TFP study but does reach a similar conclusion that the current 4.3% X factor is inadequate. County asserts that had there been in place an X factor of 11.06% from the inception of the alternative regulation plan, AI on total company basis would have achieved an annual return of 11.36%. County is not advocating the use of an 11.06% productivity factor but presents this information to highlight how reasonable a 6.5% X factor is.

In order to ensure that AI's noncompetitive rates are established at just and reasonable levels, City/GCI recommend the adoption of a 6.5% X factor. The 6.5% figure is taken from the FCC price cap order, which adopted the "CALLS" settlement proposal, whereby interstate prices are reduced by a 6.5% offset against inflation. Said 6.5% X factor includes a .5% consumer dividend. City/GCI rely upon the testimony of Dr. Selwyn. Selwyn testified that the 6.5% X factor would be appropriate because it is based on unseparated total company productivity results; it is based on FCC Staff's analysis of local exchange company productivity and input price differential for the 1985-1995 time period; the FCC Staff analysis was based on physical output measures (first local calls and later minutes of use); and it was accepted by the BOC's as part of the overall CALLS Proposal.

City/CUB acknowledge that the FCC declined to call the 6.5% X factor as used in the CALLS Proposal, a “productivity number” but instead the FCC chose to call it a “transitional mechanism that operates to reduce rates.” No matter what the label, City/CUB contend, the FCC X factor and the Illinois X factor serve the same purpose, that is to mimic competitive forces and maintain AI’s rates and earning at reasonable levels. Despite the FCC’s reluctance to call its X factor a productivity number, CUB urges the adoption of the 6.5% X factor as it serves the same purpose, no mater what the label.

AI’s Response

AI opposes the adoption of the FCC’s 6.5% X factor in this proceeding. AI opines that the FCC’s X factor is not a valid productivity measure. AI presented the testimony of Dr. Meitzen in support of its opposition to the FCC X factor. Meitzen testified that the FCC X factor was designed not as a productivity measure but a transitional mechanism, one that was imposed to reduce interstate carrier access rates. Ultimately, Meitzen concludes that the transitional mechanism would serve only to transform the Illinois X factor into a mechanism that serves only to reduce rates at a certain pace while at the same time it would not be linked to a specific measure of productivity. (AI Ex. 2.2, at 19.)

Staff’s Response

AI numerated other flaws with the FCC X factor. AI claims that the FCC staff used outdated data and improperly used only a single physical measure of local output. Further, the FCC’s output specification did not match the sources of revenue growth. Also, AI argues the use of a residual earnings method to estimate capital costs by the FCC was improper.

Similarly, Staff contends that the study used by the FCC to arrive at its 6.5% X factor is flawed. Staff argues that it produces inaccurate output growth, input price growth and productivity growth estimates. Specifically Staff cites the following flaws with the FCC study: 1) proxying local output by local calls only, when in fact local output consists of many services including lines and vertical services which grow at different rates than minutes, 2) excluding miscellaneous revenues from the output measure, and 3) inappropriately computing capital input prices based on realized rather than expected rates of return. Staff Ex. 16.0 at 10-16. Like AI, Staff notes that the FCC no longer characterizes its X factor as a productivity offset but considers it a policy instrument. Staff Reply Brief citing Ameritech Ex. 2.2 at 19 (Sixth Report and Order) Staff urges the rejection of City/GCI’s 6.5% X factor as methodologically flawed and greatly in excess of AI historical productivity growth.

b. Consumer Dividend

AI and Staff have divergent views with respect to the inclusion of a consumer dividend. Staff supports maintaining a 1% Consumer dividend in the Price Cap Formula. AI urges the Commission not to extend a consumer dividend for another term of the Plan. AI suggests that the consumer dividend was made apart of the Plan "to ensure that customers received 100% of the benefits of the Company's first productivity gains under the plan." (AI Brief at 40.) However, AI, contends that the consumer dividend actually had the effect of flowing through all of the productivity gains that AI achieved during the first five years of the plan and an additional .8 % that AI did not achieve. (Id.) AI argues that the Commission did not have the benefit of real data when it imposed a 1% consumer dividend in the initial Plan. Now, however, AI concludes, based upon actual experience, the imposition of a consumer dividend in unwarranted on a going forward basis.

Staff urges the Commission to extend the consumer dividend and recommends such dividend be 1%. Staff contends that in inclusion of a consumer dividend fulfills the requirement under Section 13-506.1 (b)(5) of the Act wherein an alternative regulation plan must specifically identify how ratepayers will benefit from efficiency gains, costs savings resulting from regulatory change and improvements in productivity due to technological change. Staff takes issue with AI's statement that the consumer dividend had the effect of flowing through all the productivity gains made by AI. Staff contends that on a company wide basis, AI passed along less than half of its productivity gains during the initial five years of the plan. Further, Staff notes, AI passed along no productivity gains of its competitive services. Staff suggests that AI's real problem with the consumer dividend is that prices of non-competitive services fell by more than overall company productivity gains. Staff Reply Brief at 16.

City/GCI recommends that a consumer dividend be included in the PCI formula should the Commission rejects its suggested X factor. A consumer dividend acts as an incentive on the incumbent carrier to improve its overall efficiency. It also acts as a form of consumer protection so as to allow a consumer to receive at least some specific benefits of price cap regulation. Further, City/GCI argue that AI's position that a consumer dividend should be eliminated because it achieved less cost savings than the price cap flowed back to consumers must be rejected as refuted by the record which City/GCI contend shows AI's earnings skyrocketed under the plan in spite of price index rate reductions.

Commission Analysis and Conclusions

The Commission further concludes that the X factor should be set at 4.3% (inclusive of productivity differential, input price differential, and consumer dividend) on a going forward basis. The calculation of the LEC industry's productivity and input price performance as performed by AI witness Meitzen, is appropriate for use in the price index. Additionally, the deflated revenue approach to measure output is also appropriate for use herein. The deflated revenue approach is widely accepted, including its prior use by this Commission. We see no reason to deviate from the use of the deflated revenue approach on a going forward basis. City/GCI contentions of methodological shortcomings with TFP, to the contrary are not persuasive. We reject the use of 6.5% as the productivity factor as proposed by City/GCI. We find it very telling that even the FCC has not adopted 6.5% X factor as a productivity factor but rather prefers to call it a transitional mechanism or a policy instrument. There remain serious methodological issues associated with the FCC Staff's prior analyses which forms the basis for a 6.5% X factor.

An alternative regulation plan, at a minimum, must satisfy several criteria as detailed in 13-506.1(b) of the Act. The Commission may approve a plan or a modified plan only after it finds that the plan satisfies those minimum requirements as stated herein above. As such, AI's alternative regulation plan or any extension thereof must identify "how ratepayers will benefit from any efficiency gains, costs savings arising out of the regulatory change, and improvement in productivity due to technological change." 13-506.1(b)(5). Just as the Commission was persuaded in 1994, we are again persuaded that an additional component to the price regulation formula is the most direct and appropriate way to achieve the goal of identifying how ratepayers will benefit from the extension or modification of AI's plan. We agree with Staff and City/GCI and conclude that a 1% consumer dividend should be included within the X factor to assure that ratepayers will benefit from any efficiency gains, costs savings arising out of the regulatory change, and improvement in productivity due to technological change.

AI in its Briefs seems to suggest that under the Plan, ratepayers were only to receive a consumer dividend for the first term of the plan. The implication therefore is that once the original term of the plan expired, so to would the consumer dividend. We reject this implication. Ratepayers are to receive the first cut from any improvements which arise from technological and regulatory change under the original term of the Plan and just as importantly any modification or extension thereof. Given our position relative to earnings sharing, the use of a consumer dividend is vital for this modified plan to maintain compliance with the Act.

3. (Z) Factor

The Z factor accounts for any impact associated with changes made to the Federal Communications Commission's ("FCC") rules, and/or with some other change which is quantifiable and outside AI's control, and has not been picked up in the economy wide inflation factor. We have previously held that exogenous factor treatment should be allowed only for costs: 1) which are truly outside the Company's control; 2) which can not be picked-up on in the economy-wide inflation factor, to avoid double-counting; 3) which are verifiable and quantifiable, to ensure that the effect of the exogenous event can be accurately determined without protracted, controversial regulatory involvement; and 4) the changes must exceed $3 million.

AI's Position

AI proposes that the Z factor continue to be a component of the price cap index mechanism. AI does however propose a change as to when such a Z factor change can take place. AI also requests that on a going forward basis, the Commission expressly recognize the exogenous treatment of Commission mandated rate reductions.

Under the current plan an exogenous change, if approved by the Commission, is inserted into the formula and is allowed to take place at the next annual filing. AI proposes that exogenous treatment for rate reductions should be allowed to take place immediately, without waiting for the next annual filing under the Plan. (AI Initial Brief at 41.)

Staff's Position

Staff also proposes that the Z factor continue to be a component of the price cap index mechanism. Staff acknowledges that the Commission would want flexibility built into the price cap plan to deal with issues that cannot be satisfactorily dealt with elsewhere and the Z factor is a place where such discretion could be exercised. (Staff Initial Brief at 19.) On a going forward basis, Staff proposes that AI must file for exogenous change treatment within 30 days of such revenue reduction with the specific rates it wishes to change. Staff would then review the proposed rate changes. Final rate changes necessary for revenue recovery would then be implemented no later than 60 days after the initial AI filing. Additionally, Staff proposes that Commission reserve the ability to delay rate changes until the annual price cap filing, as well as deny revenue neutrality. Further, Staff states that the Z factor is not intended nor should it be used as a earnings management tool.

GCI/City's Position

City/GCI contend that the exogenous change factor should remain unchanged. City/GCI reject AI's proposal of extending exogenous change factor treatment to Commission mandated rate changes. CUB argues that to allow automatic offsets for all Commission mandated rate changes would circumvent the Commission's discretion to determine whether the price regulation formula is just and reasonable absent the offset. City/GCI contend that the Z factor is based on the concept of revenue neutrality. To allow exogenous treatment for Commission mandated rate reductions, in City/GCI opinion, is inconsistent with revenue neutrality and price cap regulation. Further City/GCI argue, that under the AI proposed change, AI would receive more favorable treatment under price cap regulation than it would have received under rate of return regulation. Under rate of return regulation, rate changes are only allowed upon a showing that said change is necessary to maintain just and reasonable rates.

Next, City/GCI reject AI's proposal based upon its perception that such a proposal would do a way with Commission oversight of Z factor treatment. City/GCI also rejects Staff's proposal which would allow Z factor changes to be implemented within 60 days of AI's filing. City/GCI claim that 60 days is inadequate to determine the revenue effect of a rate change because to the lack of reliable demand data. City/GCI is also concerned that any Commission ordered rate reduction could result in a non-competitive services rate increase. Lastly City/CUB argue that one of the intended benefits of alternative regulation was to decrease regulatory burden. A single annual filing was intended to accomplish reduced regulatory burden. The Z factor proposals suggested by AI and by Staff serve to increase regulatory burdens by creating a new category of cases which Staff and other interested parties would have to examine, and examine on an expedited basis.

AT&T's Position

AT&T also opposes AI's request that the Commission expressly recognize that exogenous treatment of Commission mandated rate reductions are appropriate under the Plan. Should the Commission adopt AI's proposal, AT&T envisions a situation wherein AI would be entitled to exogenous treatment where the Commission mandated a rate reduction as result of a Commission determination that AI's rates were unjust and unreasonable. AT&T also opposes AI's proposal for immediate reductions

Commission Analysis and Conclusion

The Commission concludes that the Z factor continues to be a necessary component of the price cap index formula. The Commission had found in the alternative regulation order that an exogenous change factor is necessary because a price cap formula is an over simplification of a complex public policy. Order at 61. The Commission recognized then, as it does now, that the formula, without a Z factor cannot always reflect changing circumstances and balance competing interests fairly. However, on a going forward basis, clarification of the Z factor is appropriate. The Commission is persuaded by Staff's proposal that requires AI to make a exogenous treatment filing within 30 days of the exogenous event which it deems triggers the need for a rate change, together with the specific rates it wishes to change.

Further, an exogenous event may include a Commission mandated rate reduction. In the alternative regulation order the Commission recognized that a Z factor is necessary to allow for changes which truly are outside of AI's control. Order at 62. To automatically prohibit exogenous treatment for Commission mandated rate reductions is arbitrary and inconsistent with the theory behind providing for a Z factor. If AI claims an event has occurred which it feels requires exogenous treatment, AI must satisfy the four criteria as set out in the Order at 62, regardless of whether such an event was a result of a Commission mandated rate reduction or otherwise.

In all other respects the Z factor shall remain as originally ordered, including the actual application of a Commission approved exogenous event on an annual basis. The Commission will continue to retain the oversight it has experienced over the initial term of the Plan and AI, Staff, and interested parties will not be subjected to the additional regulatory burden of a new category of cases. As AI recognizes, and the Commission agrees, the exogenous change factor under the initial term of the Plan has operated as the Commission expected.

4. Service Quality/Q Factor

The Act requires that an alternative regulation plan serve to maintain the quality and availability of telecommunications services. 210 ILCS 5/13-506.1 (b)(6) Under the Plan the Commission concluded that the best way to eliminate AI incentive to reduce service quality will be to adopt a service quality component to the price cap formula which penalizes AI for not maintaining service quality. Under the Plan the Commission adopted eight separate quality of services measures. For each measure, AI receives a score of zero if it meets the benchmark, and a score of -.25 if it fails to meet a specific benchmark. Without the benefit of history, the Commission concluded that its Q component would provide considerable incentive for AI to meet its benchmarks. Order at 59.

Staff recommends that the Q factor be eliminated from the price cap index. Staff has recommended that the issue of service quality be addressed outside the price cap index in separate proceedings. AI, City/GCI have alternative proposals as to how to handle the issue of service quality.

Commission Analysis and Conclusion

We agree with Staff and conclude that the issue of service quality be addressed within the alternative regulation plan but outside the scope of the price cap index itself. A detailed examination of the issue of service quality can be found in the Service Quality Section of this order.

C. Pricing Flexibility

AI's Position

AI recommends that the Plan be modified on a going forward basis to allow the Company greater flexibility to increase prices. According to AI, pricing flexibility would "allow it to 1) adjust rates to the more competitive marketplace, and 2) allow it to move toward a more "economically efficient rate structure." (Staff Reply Brief at 21, citing Ameritech Initial Brief at 6.) Under the Plan, AI's pricing flexibility is limited to 2% over the percent change in the PCI and a rate cap was imposed on basic residential services for five years. (Ameritech Initial Brief at 42, citing Order at 64-65, 70.) AI states that because of the severe limitation placed upon it, it has not been able to increase noncompetitive rates since the Plan went into effect.

In support of its argument for increased pricing flexibility AI argues that its residence network access lines are priced too low and being subsidized by other services. AI contends that reasonable per service rate increase be allowed to effectuate a smoother transition to competition and a more efficient rate structure. AI has alternative proposals relative to pricing flexibility. Should the Commission grant its request for rate re-balancing, then in that event AI requests the ability to increase individual rate by 5% annually over existing levels, while at the same time decreasing rates of other services to maintain compliance with the PCI. (Ameritech Initial Brief at 42.) AI asserts less upward pricing flexibility is needed if rate re-balancing is accepted. Should the Commission reject AI's rate re-balancing proposal, then AI requests authority to increase individual rates up to 10% per year with a cap of 30% during a 5 year period. Id. AI asserts that Staff's and City/GCI's objections to pricing flexibility are unprincipled. AI contends that Staff and City/GCI's view is shortsighted in that both fail to see the harm to ratepayers when AI's rates fail to cover their costs and are unsustainable in a competitive marketplace. Further, AI asserts that pricing flexibility allows for more gradual increases as opposed to sudden changes in prices resulting from proceedings such as rate re-balancing. (Id at 43.)

Staff's Position

According to Staff, AI has failed to explain why it needs any significant level of pricing flexibility for services for which it has no competitors. Should either of AI's proposals be approved, Staff contends the upward pricing flexibility allows for AI to increase noncompetitive rates where no competitive pressure exists. This type of conduct, Staff asserts, is called "Ramsey pricing." Basically, Staff charges that AI pricing flexibility proposals are nothing more than a desire to charge customers more with no fear of losing customers to competitors. Staff concludes that the 2% pricing flexibility remains appropriate and should be implemented going forward.

GCI/City's Position

Likewise, City/GCI argue AI's pricing flexibility proposals be rejected. Like Staff, City/GCI contend that AI has offered no evidence that the two percent pricing flexibility has impeded AI ability to react to market forces. City/GCI further argue that no evidence was presented indicating AI lost market share as a result of the two percent limit upon pricing flexibility. Also, City/GCI argue that AI's proposals allow AI to modify rates without regard to cost.

Commission Analysis and Conclusion

The Commission concludes that the current 2% pricing flexibility afforded to AI be maintained on a going forward basis. Essentially, AI's difficulty with the current 2% upward pricing flexibility limit is that it has not been able to benefit from that limit. However, the rationale for increasing pricing flexibility is not supported by the record. There is little or no evidence indicating AI's non-competitive services have suffered market share loss or that it has been unable to react to market forces. AI's argument relative to costs being at least at their long run service incremental cost is compelling and is addressed in the rate re-balancing section in this order. However, there has been no evidence presented which persuades us to increase pricing flexibility for services which have little or no competition.

D. Proposed New Component Merger Related Savings/M Factor

This Commission approved the merger of Ameritech Corporation and Southwestern Bell Corporation ("SBC"). (Merger Order Docket 98-0555). In the Merger Order the Commission ordered that AI track all merger related costs and savings. Pursuant to the Merger Order, information on merger related costs and savings are to be submitted annually with AI's annual price cap filings until an updated price cap formula is developed in 98-0252. In the Merger Order the Commission anticipated that an updated price cap formula could be developed in this proceeding that would permanently flow through 50% of net actual merger savings to customers. Further, the Merger Order required the retention of a third party auditor to develop and establish accounting standards so that the Commission could identify merger related costs and savings. In the event there are merger related savings, 50% of those saving allocable to AI are to be allocated to Illinois ratepayers.

AI's Position

AI's position is that a permanent solution to merger savings cannot be adopted yet. AI contends that the Merger Order requires that permanent rate adjustments be based on actual net merger savings, and since AI will not reach a "going level" of merger savings until the first 1/4 of 2003, it is premature to address the issue of merger savings. AI recommends that the amount of net merger related saving should be based upon the year 2002. However, since there was no consensus of the parties, AI suggests that merger saving continue to be handled in the annual price cap filing on an interim basis and that a permanent solution be deferred to another proceeding.

In its "New Components" section of it Reply Brief, Staff states that it would prefer that merger saving be handled through a one time permanent adjustment to the PCI but then states that the Commission could also calculate a "M" factor based upon merger savings as well. In the Merger Costs and Savings section of its Reply Brief, Staff again suggests that the Commission may consider two options, either make a one time adjustment to the PCI, presumably whenever a final determination of merger related savings can be obtained, or include a merger related savings factor to the price cap formula. With respect to AI's proposal that any permanent solution be based upon year 2002 data, Staff disagrees. Staff argues that AI's proposal will not capture all merger related costs and savings because by 2002 only 96% or merger related savings will be actualized. (Staff Reply Brief at 33.) Staff recommends that the terms of the merger condition remain in effect until the Commission completes its review of this modification to the Plan. Staff suggests that this modified plan be reviewed in four years, with a final order in place before July 1st of the fifth year. (Staff Reply Brief at 32.) By 2004, Staff contends, the extent of actual merger related savings will be known and that a one-time adjustment to the price cap index could then be made.

Staff's Position

Alternatively, Staff proposes that the price cap formula be modified at this time to reflect 50% of SBC's current estimate of merger costs and savings. Staff opines that since merger costs and saving amounts have already been reviewed by SBC's upper management and analyzed by its merger integration teams, the current estimate of net merger related costs and saving has a high probability of being achieved. (Staff Reply Brief at 34.) In Staff's view, a merger costs and saving factor would reduce the regulatory burden of determining the actual amount of costs and savings on an annual basis. Although Staff did not specifically provide in its briefs exactly what if thought the M factor should be, it did provide data which it extrapolated by using data from the merger case and that which was based upon evidence provided by Staff in this docket. (Id. at 35.)

GCI/City's Position

City/GCI recommend the use of an M factor in the price cap formula. Because there is only specific data on merger saving for three months in 1999, City/GCI propose that the M factor by initially established on the basis of the level of savings that Ameritech and SBC Boards of Directors had anticipated when the "transfer ratio" value was set. Applying the 50% ratepayer allocation of savings that the Commission adopted in the Merger Order and Ameritech/SBC's anticipated level of savings, would result in a M factor of 4.8%. Finally, City/CUB suggest that following a review of this modification to the Plan, should the Commission determine that 4.8% M factor be too low or too high, the Commission can adjust the PCI up or down accordingly.

AI's Position

AI specifically opposes City/GCI's proposal. The Company notes that making an adjustment now based on the same estimated data presented in Docket 98-0555 would be inconsistent with the plain terms of the Order, which AI states, requires the adjustment be based on actual data. Even more importantly, AI contends is that Dr. Selwyn's approach to calculating these savings on an estimated basis produced vastly excessive savings amounts in Docket 98-0555. The same problem exists in this docket, since GCI is relying on precisely the same analysis. Since the Commission rejected Dr. Selwyn's approach in Docket 98-0555, AI argues that there is no basis for adopting it here. (Merger Order at 147.)

Commission Analysis and Conclusion

The Commission concludes that GCI's proposal should not be adopted. We were clear in Docket 98-0555 that merger savings adjustments would not be based on the estimates but rather actual merger related savings. We agree with Staff's recommendation that the terms of the merger conditions shall remain in effect until the

Commission completes its review of AI's annual filing for the calendar year 2003. The extent of actual merger related savings will be known in time for the Company's annual filing on April 1, 2004, at which time a one-time adjustment to the price cap index should then be made.

E. Baskets

1. Generally

Under the terms of the original Plan, non-competitive services were divided into four baskets. Originally each of the four baskets consisted of the following: 1) the Residential basket contained access and Band A, Band B, and Band C usage; 2) the Business basket consisted of business access, Band A through D usage, and certain discretionary services; 3) the Carrier basket consisted of switched access, special access, cellular access and other various carrier services; 4) the Other Services basket contained directory services, directory assistance, operator services, payphones, private lines, discretionary residential services and name and address service in Chicago. Order at 66 and 69. The baskets were structured to ensure that all customer classes benefited equally from price regulation, and, with respect to the splitting of residence services between the Residential and Other baskets, to facilitate the application of the five-year rate cap to basic network access lines and usage. (Order at 68-69.)

The four basket system has been maintained throughout the life of the Plan, however, the makeup within each basket has changed. As provided for within the Plan, AI may withdraw services from baskets by reclassifying them as competitive. Since the Plan became effective, and including those reclassifications currently under investigation in Docket 98-0860, Staff claims that revenues subject to the Plan, i.e. from services within the four baskets, have declined by $350 million. In particular, Staff asserts revenues from within the Business basket have declined by 94%.

2. Proposed Modifications to the Basket Structure

a. Consolidation of Baskets

AI's Position

On a going forward basis, AI proposes that all services which remain under the Plan be consolidated into a single basket. Because many services within the Business and Carrier baskets have been reclassified as competitive and/or because many carrier services are now priced on an incremental cost standard, AI suggests that there is no longer a need for multiple baskets. AI contends there is a benefit to a single basket system. AI asserts that a single basket would allow greater flexibility in structuring discounted service packages for customers and well as permit a meaningful opportunity to restructure rates across customer classes. Alternatively, AI proposes that all residential related services be combined into one basket.

Staff contends that the four basket system should be maintained. Generally, Staff objects to AI's single basket proposal because of its concern with customer class discrimination. "[C]ustomer class discrimination occurs when a specific class does not receive the rate reduction given to other classes. To avoid such discrimination, the Commission placed residential, business and carrier services in separate baskets. Therefore, when rate reductions are required in an annual filing, each customer class receives similar benefits. Any combining of service baskets eliminates the protection that certain customers currently receive." (Staff Reply Brief at 25.)

Staff's Position

Despite what Staff views as the premature reclassification of certain business services by AI, Staff maintains the need for the four basket system remains. Even if AI's business reclassifications are not found to be improper in Docket 98-0860, Staff contends that the need for a separate Business basket continues given the potential for new business services which could cause a basket to expand significantly. Given that access charges are non-competitive services Staff argues that the Carrier basket should remain. Further, Staff claims that the Residential basket must continue in as much as competition does not exist in any meaningful sense for those services.

GCI/City's Position

City/GCI also objects to AI's modified basket structure proposal. They argue that if AI were given the chance to unilaterally and without constraint shift revenue recovery among all of its services, the protections against Ramsey pricing and the need to provide all consumer classes with rate reduction and innovation would be lost. City/GCI arguments as why the four basket structure should remain mirror those made by Staff.

AT&T's Position

AT&T agrees with Staff and City/GCI that on a going forward basis, the four basket system be used. Further AT&T maintains that AI's rationale for co-mingling all the baskets into one has been undermined by the Hearing Examiners' Proposed Order in Docket 98-0860, wherein the Hearing Examiners concluded that AI had prematurely classified all the business services under investigation in that docket. Procedurally, AT&T notes that should the Commission accept the findings and conclusions in the HEPO, all those services under investigation previously reclassified as competitive, would be returned to the Business basket. On a more general basis, AT&T takes issue with the proposition that unless a basket contains several services, it should be eliminated. Even, if the services at issue in 98-0860 were found to be competitive at the time of reclassification, AT&T argues that it is conceivable that in a developing market, new business services would be created and therefore need a home in the Business basket.

Further, AT&T asserts that the premise of the four basket structure was to ensure that all customer classes were treated equitably, free from discrimination and cross subsidies. (AT&T Reply Brief at 6.) AT&T sets forth the statutory underpinnings behind the four basket system. Pursuant to the Act, no alternative regulation plan may be adopted which would unduly or unreasonably prejudice or disadvantage any particular customer class. AT&T Reply Brief at 5 citing 220 ILCS 5/13-506.1(b)(7). AT&T quotes from AI's Initial Brief wherein AI stated "[t]he [four] basket structure and residential rate protection functioned precisely as the Commission intended. All rate reductions required by the Plan were flowed through equitably to each customer group." (Id. at 6, citing AI Initial Brief at 30.) AT&T concludes that the four basket structure is a tried and true mechanism to ensure that all customer classes are protected and treated equitably.

b. Calling Plans

Staff's and GCI/City's Position

Staff proposes that residential calling plans be transferred from the Other basket to the Residential basket. In Staff's opinion calling plans are not truly discretionary services as no customer could make use of the network without obtaining these services. Additionally, Staff argues that by placing calling plans within the Other basket renders the price cap plan less effective at ensuring that benefits are passed on to the most captive customer. City/GCI concur in Staff's proposed treatment of calling plans.

AI's Response

AI opposes Staff and City/GCI's proposal to move calling plans from the Other basket and into the Residential basket. Under the Plan, AI explains, new services are excluded for one year and new residential services are then placed in the Other basket, together with other optional residential services. AI views calling plans as an optional service as they offer customers choices they previously did not have. AI contends its interpretation of calling plans as an optional service is consistent with the FCC definition of a new service under its price cap plan. Finally, AI suggests that its view is consistent with that of the Commission's in that the Residential basket was intended for basic services while the Other basket was intended for discretionary services.

c. Elimination of Certain Services from Baskets

AI's Position

AI recommends that 911 services, UNEs, wholesale and carrier access charges be excluded from the operation of the index, i.e. excluded from the basket structure. AI asserts that by previous Commission order, 911 services and UNEs have been excluded from the Plan. (AI Initial Brief at 46, citing Order and 96-0486/0569.)

AI argues that because TA96 requires that UNE prices must be set at TELRIC, plus an appropriate allocation of common overhead costs, it remains appropriate to exclude UNE services from the basket structure. With respect to wholesale services, AI argues said services should be treated similarly to UNEs, because, pursuant to TA96, wholesale services must also be priced based upon a cost standard. AI contends that it is entitled to set its wholesale rates based on a costs standard and TA96 does not contemplate any further reductions. (Id at 47.) AI makes a similar argument with respect to switched carrier access rates. Because the Commission requires switched carrier access rates to be set at LRSIC plus common overhead allocation, further potential decreases inflicted by the basket structure would be impermissible. AI asserts that further downward adjustments based on the price index would result in carrier access rates which are below the level which the Commission has already found to be reasonable and equitable. (i.e. LRSIC plus common overhead allocation.)

Consequently, AI proposes those services which the Commission has previously excluded from the basket structure continue to be excluded, and wholesale and carrier access charges be excluded on a going forward basis. Finally, AI contends that the cost changes reflected in the X factor do not translate into changes in LRSIC/TELRIC costs or common costs since the X factor reflects changes in actual operating costs while LRSIC and TELRIC already assume the use of forward looking technologies and operating practices. According to AI, applying the X factor to carrier access charges or UNEs would improperly double count productivity gains.

GCI/City's Position

City/GCI reject AI's proposal to eliminate UNEs, wholesale services and carrier rates from the price cap. City/GCI reject as a premise their exclusion because they are based on LRSIC and TELRIC studies. Because these rates do contain a contribution towards common overhead costs, cost reductions anticipated under the Plan could not result in prices lower than LRSIC or TELRIC costs. However City/GCI state the Plan could serve to reduce overhead costs. City/GCI Reply Brief at 33. Further, they note that common overhead costs are exactly the costs that would be reduced as a result of general productivity and costs savings measures. (Id.)

City/GCI witness TerKeurst refutes AI's claim that includes UNE, wholesale service and carrier rate in the price cap will result in double counting of productivity gains. She claims that there is no evidence to support that AI has accurately predicted every change, including technology changes, input levels and input mixes that will occur for these services.

AT&T's Position

AT&T also addresses the issue of the make-up of certain baskets. First, with respect to the Carrier basket, AT&T proposes that UNEs, Interconnection and Transport, and Termination services should be added and that carrier access services should remain therein. AT&T contends that continuing to include carrier access services in the price cap mechanism is consistent with forward looking cost based pricing of switched access services. AT&T posits that including carrier access services in the price cap mechanism will ensure that switched access rates properly reflect cost reductions as AI's cost of providing access services declines over time.

AT&T contends AI's arguments regarding why certain services should be excluded from the alternative regulation plan are at best abbreviated. AI's stated rationale for excluding UNEs from the price cap mechanism is that the Commission excluded UNEs from the Plan in its Order in 96-0486/0569 because the federal Act requires that UNEs be set at TELRIC plus an appropriate allocation of shared and common costs. AT&T states that although the Commission in its Order in Dockets 96-0486/0569 declined to include UNEs, interconnection, termination, and transport services in the Plan, it did so with the caveat, "at the present time." AT&T argues that the language "at the present time" used by the Commission means that the Commission is free to reconsider the issue. AT&T asserts now is the time to revisit the issue.

AT&T contends that the reasons the Commission found for excluding UNEs from the Plan before are no longer in existence. One reason to no longer exclude such services is the extremely generous shared and common cost markup AI is allowed to assess to UNEs. Further AT&T asserts, customers do not have competitive alternatives for UNEs; hence, UNEs are appropriately classified as noncompetitive. With respect to AI's contention that UNE prices must be set at TELRIC plus common overhead costs, AT&T argues that the rates adopted by the Commission in the TELRIC Order are not price floors but rather price ceilings. Because the price cap formula is designed to capture AI's efficiency gains, AT&T asserts there is no reason that AI's efficiency gains should not also flow to the UNEs, interconnection and transport and termination services. AT&T argues that the Commission should not deprive CLECs and their customers of these efficiencies. AT&T concludes that UNEs should be included in the Carrier basket.

With respect to carrier access services, AT&T contends that AI misstates the Commissions order in 97-0601/0602 ("Phase II Order") in support of its position to exclude carrier access services from the price cap formula. AT&T Reply Brief at 14. AT&T contends that the Commission did not set AI's carrier access rates *at* LRSIC plus common overhead allocation, but rather the Commission required AI to set carrier access rates at LRSIC, and then gave AI the right to include in its carrier access rate an allocation of shared and common costs not to exceed but be capped at 28.%. (Id at 15.) AT&T supplied the following quote from the Phase II Order:

> Accordingly, we adopt the shared and common cost percentages for switched access rate elements contained in AT&T Gebhardt Cross Ex. 1A, page 3, and conclude *that the maximum shared and common cost contribution shall be 28.86%* for both Ameritech's and GTE's cost-based switched access rate elements. Order dated March 29, 2000, ICC Docket Nos. 97-0601/0602, p. 51 (emphasis supplied).

AT&T asserts that operative word in the quote above is "maximum." Staff witness Koch also agreed that the Phase II Order does not *set* the shared and common cost allocation *at* 28.86% but, rather, *caps* the shared and common cost allocation.

AT&T counters AI's assertion that any reductions to its LRSIC costs and common overhead allocations for carrier access services can be reflected via updated cost studies. AT&T points to GCI witness TerKeurst's testimony wherein she stated that it took almost three years to litigate dockets 97-0601/0602. AT&T's point is that the delay associated with 97-0601/0602 demonstrates, the process of investigating and litigating AI's cost studies is almost inevitably a lengthy, contentious and resource intensive process for both the Commission and the interested parties. As such, AT&T suggests the process of reviewing or updated AI's costs studies are not as simple or expeditious as AI contends.

AT&T agrees with CUB in that price cap provisions could provide a convenient, low cost and routine approach to updating rates derived initially through cost studies, thus avoiding or deferring lengthy and contentious proceedings to evaluate cost studies and update rates for these services, and furthering the goal of reducing regulatory costs. (AT&T Reply Brief at 15, citing CUB Initial Br. at 67.)

AT&T also agrees with GCI witness Terkeurst relative to what it views as AI's inability to accurately predict future changes in operating costs in LRSIC/TELRIC calculations. AT&T's asserts that application of the PCI to carrier access charges will not result in double counting of costs. AT&T therefore concludes that such services should be included within the Carrier basket and customers purchasing those services should receive the benefits of the price cap mechanism. (AT&T Reply Brief at 7.)

AT&T argues that wholesale services should continue to be included within the Plan. While AI contends that nothing in TA96 contemplates further reductions, AT&T posits that nothing in the federal Act precludes further reductions to wholesale rates. AT&T notes that AI itself concedes that wholesale rates must decline with their retail counterparts. Thus AT&T concludes, to the extent AI experiences cost reductions, wholesale services should also benefit from those reductions through the price cap mechanism. AT&T Reply Brief at 13-14. Moreover, AT&T explains, wholesale services have been included in the alternative regulation plan for almost six years since the Commission adopted its Wholesale Order. AT&T contends the Commission should continue to include wholesale services within the alternative regulation plan for the same reasons carrier access charges and UNEs should be included.

AT&T proposes a further modification with respect to wholesale services. AT&T recognizes that although wholesale services being provided by AI are in fact carrier services, it is more appropriate that said services follow their retail companion. Finally, AT&T notes that where a wholesale service is included within the same basket as the corresponding retail service, the same consumer classes will be addressed independent of their customer classes. This, AT&T concludes, will allow customer classes to be treated equitably and free from discrimination and cross subsidies.

Commission Analysis and Conclusion

The Commission concludes that the current four basket structure should be continued on a going forward basis. AI's arguments for a modification are not persuasive. Since the opening of Docket 98-0860, AI returned all the residential services which were previously reclassified as competitive to a non-competitive status. Serious questions have been raised as to the propriety of the business services AI reclassified as competitive. Under the Plan, provisions were made allowing for services to be returned to a noncompetitive status as well as new services being added to baskets. The elimination or consolidation as proposed by AI does not further the goals of protecting a customer class. The Commission finds that a four basket structure continues to ensure that all customer classes are treated equitably, free from discrimination and cross subsidies.

We further conclude that AI has properly treated residential calling plans as new services and has properly assigned them to the "Other" basket. Calling plans are optional. A customer is not required to enter into a calling plan before usage may begin and therefore a customer's decision whether to enter into a calling plan is discretionary. The mechanisms currently in place for new services and how they are to be treated within the PCI shall remain on a going forward basis.

We conclude that 911 services should continue to be excluded from the operation of the price cap index. 911 services have essentially been set at cost to promote public safety objectives. Price decreases would then have the effect of lowering rates below costs. We also recognize that price changes to 911 services would be difficult for municipalities to manage as 911 surcharges are typically approved through referenda. As such, these charges cannot be readily modified.

With respect to UNEs, wholesale and carrier access charges, the Commission concludes said items shall not be excluded from the operation of the index and shall be included within the basket structure. UNEs shall be made apart of the Carrier basket. Wholesale rates shall remain apart of the Carrier basket. Carrier Access Services shall remain in the Carrier basket.

Ultimately, we are persuaded by the positions of AT&T and City/CUB with respect to the inclusion of UNEs, wholesale services and carrier access rates within the price cap mechanism. Our conclusion relative to these issues is uniform and consistent.

Though we had previously withheld application of the price cap mechanism to UNEs in the TELRIC Order, we agree that now is the appropriate time to reassess our position. AI is the beneficiary of generous shared and common cost markups which AI is allowed to assess to UNEs. Further, customers do not have competitive alternatives for UNEs and therefore UNEs are appropriately classified as noncompetitive. For these reasons we conclude that it is appropriate to reassess whether to include UNEs within the price cap mechanism.

With respect to UNEs, the rates adopted by the Commission in the TELRIC Order shall be considered as price ceilings and not as price floors. As with UNEs, the carrier access rates adopted by the Commission in the Phase II Order should be considered as a price ceiling and not as a price floor. The text of the order cited above by AT&T clearly states the intention of the Commission in this regard. AI's interpretation is flawed.

We are similarly persuaded to continue to include wholesale rates within the price cap mechanism. Our Wholesale Order does apply an avoided costs standard, similar in effect to those costs standards as imposed upon UNEs and carrier access rates. However, we note that there is nothing within the federal Act to preclude further reductions to wholesale rates. We agree with AT&T in that to the extent AI experiences cost reduction, wholesale services also benefit from those reduction by operation of the price cap mechanism.

d. Reinitialization of APC & PCI

In our Order, the Commission set both the API and PCI equal to 100 (Order at Appendix A.), Section 2(a). Staff and City/GCI recommend that these indices, which have declined over time, be reset to 100 on a going forward basis. According to Staff, reinitialization will have the effect of affording the Plan the maximum capacity to affect rate changes. Staff acknowledges that reinitialization will primarily affect the Carrier Basket. Similarly City/GCI, state that absent reinitialization, customer purchasing services from the Carrier basket, such as switched access services and unbundled network element ("UNEs") (assuming that carrier access and other carrier services are included in the basket as GCI recommends), would not benefit from efficiency gains experienced by AI in the future. Said customers would receive no benefit because the API for the Carrier Basket is already well below the PCI. Further City/GCI contend that any rate adjustments resulting from an overall review of AI's earnings must be reflected in a reduced API/PCI.

AI opposes the reinitialization of the API/PCI indices. By reinitializing, AI argues, you effectively eliminate the "headroom". Headroom occurs when rates in particular baskets decline more than the index would have required. Reinitializing the API/PCI combined with subjecting carrier access rates to the price index, would, AI contends, require further decreases to carrier access rates in the annual price cap filing. (Ameritech Reply Brief at 38.) This result, AI concludes, is inconsistent with the Commission's Order in Docket 97-0601/602. (Id.)

Further, AI states, there is little likelihood it could offset the headroom associated with carrier access rate decreases with increases in other carrier rates. AI notes that other services within the Carrier basket are incapable of being increased as they would require another TELRIC/wholesale(resale) pricing proceeding. Additionally, AI states that it had not made any changes to the basket since it developed its headroom in 1997.

Commission Analysis and Conclusion

The Commission concludes that the API/PCIs in the existing Plan should not be reinitialized on a going forward basis. Reinitialization will effectively eliminate the headroom which has been achieved by AI during the initial term of the Plan. Reinitialization of the baskets would serve as a disincentive to AI to operate efficiently in the future.

F. Earnings Sharing

GCI/City's Position

City/GCI propose that the Commission add an earnings sharing component to the Plan on a going-forward basis. City/GCI note that, in approving a pure price cap form of regulation, the Commission stated that it would reconsider the evidence and policy considerations for earnings sharing in future review proceedings. (Order at p. 51.) City/GCI argue that the evidence in this docket demonstrates that AI's earnings have been excessive under the existing plan, and that ratepayers have received no benefit from these excess earnings. City/GCI assert that the high earnings experienced by AI could be the result of an incorrectly set price cap index, unexpected economic conditions, improper exercise of market power, improperly classified services and irresponsible or poorly managed service performance. In City/GCI's view, earnings sharing can "balance risks, incentives and rewards in the overall regulatory mechanism" and provide consumers with some protection from unexpected results. City/GCI also contend that earnings sharing lessens AI's incentives to increase earnings by sacrificing service quality or improperly reclassifying services as competitive because its actions are still subject to some review and it does not keep all of the benefits of alternative regulation, but shares them with consumers.

City/GCI recommend the following parameters of an earnings sharing provision:

- A benchmark rate of return would be set 200 basis points above the adopted weighted average cost of capital for AI;

- A cap on AI's rate of return would be set at 600 basis points above the adopted cost of capital, thereby creating an absolute after-sharing limit on AI's rate of return;

- Any earnings between the benchmark and cap rates of return would be shared on a 50/50 basis between shareholders and ratepayers and any earnings above the cap rate of return would be returned entirely to customers;

- Revenues from all services that would be included in a revenue requirement determination under cost-of-service regulation would be included in the revenue sharing calculation, except that services for which the Commission has found that AI does not retain significant market power could be excluded if all related expenses and investments were also excluded;

- The customer's portion of any shared earnings would be distributed as a one-time credit on their bills during one or more months in the following year; and

- The earnings sharing provision would require an adjustment for a year during which the prior year's earnings above the benchmark are distributed to customers, to prevent the shared earnings from incorrectly depressing current year earnings.

AI's Position

AI opposes adoption of an earnings sharing provision. AI contends that earnings sharing bring with it all of the issues and baggage associated with rate of return regulation: debate over depreciation rates; extensive reporting and monitoring of AI's investments, rate base and profitability; prudence reviews; and continuing debates over the level of profits AI's earning and how much it should be allowed to keep. Thus, AI argues that earnings sharing does not break the link between AI's cost and rates. AI views divorcing costs/earnings from rate as a critical component in price regulation. AI further contends that earnings sharing would result in higher, not lower, regulatory costs and delay.

AI also argues that earnings sharing plans blunt the efficiency incentives of price regulation. Once the 50% sharing threshold has been reached, efficiency incentives are reduced dramatically and they are eliminated altogether once the cap is reached. Moreover, because GCI's accounting adjustments flow through in rate reductions the equivalent of 1,311 basis point in earned return, AI asserts that it would be required to share before its actual earnings ever reached a reasonable level. Thus, AI contends, many of the most important behavioral benefits of price regulation will be lost.

AI further argues that earnings sharing is fundamentally inconsistent with the Commission's decision in 1994 to allow AI to assume responsibility for capital recovery. AI states that the debate over depreciation expense in this proceeding clearly demonstrates why depreciation freedom and earnings regulation are incompatible. Moreover, AI notes that City/GCI proposes that whatever decision the Commission makes on depreciation issues in this case would be frozen for the next five years to calculate sharable earnings, absent another Commission proceeding. Thus, if the Commission adopts City/GCI's earnings sharing proposal, AI argues that the Commission will <u>de facto</u> be back in the business of prescribing AI's depreciation rates. Consequently, AI opines, the Commission is no better able to fulfill its side of the regulatory bargain now – (<u>i.e.</u>, to ensure full capital recovery of long-lived plant through prices over the next 20-30 years -- than it was in 1994.) AI contends this is the policy dilemma which the Commission found unacceptable in 1994 and AI states that GCI had proposed no solution.

AI opposes City/GCI's view that earnings sharing is a "safety net" in the event the index is misspecified or as a means of controlling for the impact of economic conditions. AI argues that the Commission has now had five years of experience with the key financial components of the index. AI argues the index was not misspecified in 1994 and there is no reason to believe it will be misspecified on a going-forward basis. AI further contends that the impact of economic conditions is something that the Commission should not attempt to control. If the economy is healthy and there is strong demand for AI's services, then AI will benefit. If the economy weakens and demand for AI's services falls off, then AI will suffer. As long as the relationship is symmetrical, AI contends, the Plan is appropriate and there is no problem which needs to be "fixed". AI further disputes City/GCI's claim that earnings sharing is necessary because the AI's earnings levels prove that the annual rate reductions under the index have been "grossly insufficient". AI argues that the X factor was, if anything, too high and that this evidence is undisputed in the record.

AI also disputes GCI's claim that earnings sharing would lessen AI's incentives to inflate earnings through cost-cutting measures that harm customers, such as service quality. AI notes that there is no evidence in this record that AI intentionally cut costs associated with the provision of service to inflate its earnings. AI contends the loss of installation and maintenance personnel in 1999 had nothing to do with any of its initiatives. Moreover, AI points out that there is no economic evidence to support the theory that either earnings sharing or rate of return regulation lead to higher quality service. AI argued that, in fact, earnings sharing would make it more difficult to respond to and correct service problems when they do arise.

Furthermore, AI contends that it is legally improper to apply earnings sharing to both competitive and noncompetitive services. Section 13-506.1, by its terms, is limited to noncompetitive services. In AI's view therefore, only earnings on noncompetitive services can be shared. In order to calculate earnings on noncompetitive services, the Commission would have to accept a cost allocation methodology comparable to what AI presented. Furthermore, AI points out that noncompetitive services today are earning well below any reasonable view of AI's cost of capital and that it is highly unlikely that these earnings would increase to a level where GCI's earnings sharing benchmark would ever be triggered. Under these circumstances, AI argues that the administrative costs associated with monitoring earnings and performing the requisite allocations between competitive and noncompetitive services cannot be justified.

Finally, AI contends that the time for earnings sharing had already come and gone by 1994. Many regulators in the late 1980's and early 1990's viewed earnings sharing as a comfortable transitional mechanism between rate of return regulation and pure price regulation when price regulation was new and was perceived to be risky. However, AI argues that that period has long since passed. The Company points out that even regulators who adopted earnings sharing early on – (e.g., the California PUC and the FCC), on whose plans Ms. TerKeurst modeled her proposal -- have since moved on to pure price regulation.

Staff's Position

Staff also opposes adoption of earnings sharing. According to Staff, earnings sharing represents double regulation. Adding an earnings sharing component to price cap regulation would mean that both AI's prices and earnings would be regulated. Moreover, Staff agrees that earnings sharing would bring with it all the problems associated with rate of return regulation. Further, Staff contends that earnings sharing is impossible to implement in any meaningful fashion when some services are subject to competition while others are not. In Staff's view, imposing earnings sharing on the entire company would mean that subscribers of noncompetitive services would inappropriately share the risks and rewards of AI's management decisions in the competitive area. Staff takes the position that noncompetitive service customers are fully protected by the index and that problems stemming from competitive classifications should be addressed directly, not through the adoption of earnings sharing.

Commission Analysis and Conclusion

The Commission concludes that GCI's earnings sharing proposal should not be adopted. Earnings sharing was reviewed at length in 1994 at which time we concluded that it was not an appropriate component of the Plan. GCI's proposal in this proceeding is identical to what was recommended by Staff in 1994. We find that earnings sharing presents all of the same problems now that it did in 1994. Fundamentally, earnings sharing prevents the Commission from delinking AI's cost and rates and continues too many of the negative aspects of rate of return regulation. As a result, earnings sharing compromises the Commission's core regulatory objectives relative to this Plan and will not be adopted.

G. Monitoring and Reporting

Section 13-506.1(d) of the Act provides, in relevant part, that:

> Any alternative from of regulation granted for a multi-year period under this Section shall provide for annual or more frequent reporting to the Commission to document that the requirements of the plan are being properly implemented.

Staff and GCI/City's Position

Staff contends pursuant to statute that monitoring and reporting requirements must remain if the Commission is to extend AI's alternative regulation plan. The information supplied by AI through the monitoring and reporting requirements is valuable to the Commission, the Staff and the public in determining whether Ameritech is complying with the conditions of the Alternative Regulation Plan. (Staff Ex. 4 at 10-11.)

Staff asserts that reporting requirements are intended to "document that the requirements of the plan are being properly implemented. Therefore, every requirement or condition of the alternative regulation plan should be addressed in these reports." (Staff Ex. 4 at 10.) Without reporting and monitoring requirements, Staff argues the Commission, its Staff, and the other parties with a legitimate interest in whether Ameritech is complying with its obligations under the plan would be unable to make an informed assessment.

Further, Staff asserts, the individual reporting requirements continue to be meaningful in a regulatory sense. Similarly, Staff contends that in light of the Commission's ongoing authority to rescind alternative regulation plans which are failing to satisfy the statutory requirements for such plans, see, 220 ILCS 5/13-506.1(e), AI cannot assert that it should not be required to produce basic financial information especially, if, the information is not available from other sources. (Staff Ex. 4 at 17.)

Lastly, Staff argues that while it is true that Ameritech files some information in price cap filings, it is also true that there should be a single complete source of information regarding Ameritech's performance under the plan, which the price cap filings are not.

Annual monitoring and reporting requirements were imposed on AI by the 1994 Order and are fully set forth below:

1. Total Company and Illinois jurisdictional rate base for the preceding calendar year adjusted to reflect regulatory treatment ordered in Dockets 92-0448/93-0239.

2. Total Company and Illinois jurisdictional operating revenue and expenses for the preceding calendar year adjusted to reflect the regulatory treatment ordered in Dockets 92-0448/94-0239.

3. Other income and deductions, interest charges, and extraordinary items for the preceding year (with explanations);

4. Preceding calendar end of year capital structure;

5. Calculated total Company and Illinois jurisdiction return on net utility rate base and total Company return on common equity;

6. Statement of Sources and Applications of Funds for the preceding calendar year;

7. Description of proposed projects and amounts to be invested in new technology (regarding the Company's $3 billion infrastructure investment) for the current calendar year and a comparison with the actual projects and amounts invested in new technologies during the preceding calendar year;

8. Calculation of the current price cap index and actual price indexes including the formulas used, the inflation factor and its source, the general adjustment factor, the exogenous factor and a description of its calculation, and the service quality component and a description of its calculation;

9. A description of new services offered in the preceding calendar year, including the price of each and its effect on

the calculation of API;

10. Demand growth by revenue basket in the preceding calendar year;

11. Summary of price changes initiated under the Alternative Regulatory Plan in the preceding calendar year;

12. A demonstration that Section 13-507 of the Act has been complied with during the preceding calendar year;

13. A summary report on Ameritech's quality of service during the preceding calendar year; and

14. A summary report on the exogenous events that affected the exogenous factor of the price cap index formula.

(Alternative Regulation Order, Appendix A at 7-10.)

AI's Position

AI contends that these existing requirements could be streamlined on a going-forward basis to reduce the costs of regulation, without any loss in appropriate Commission oversight capabilities. Specifically AI objects to the form of the Infrastructure report and states that it need not be retained if the infrastructure investment commitment is not retained.

First, AI proposes items 1-6, which are earnings-related in nature, be eliminated because they are not appropriate in a price regulation plan. AI notes that the Commission's stated rationale in 1994 for requiring this information was that high earnings could provide an "early warning" that the productivity offset may have been misspecified. In practice, however, the AI asserts that the productivity offset was not misspecified and that there is no reason to believe that it will be misspecified going forward. Second, AI submits an annual report on March 31 of each year which details it's financial performance over the preceding calendar year sufficiently sets forth other information previously required. AI contends that items 8-11 and 13-14 are unnecessary because those items are addressed in the annual price cap filings.

Finally, the 1994 Order requires an annual demonstration that AI has been in compliance with Section 13-507 of the Act and the Aggregate Revenue Test during the preceding year. AI states that it had no objection to continuation of this reporting requirement, if the Commission found it useful.

AI also recommends that the Commission not establish another predetermined, formal review proceeding in its Order in this proceeding. AI points out that the Commission provided for this current review in large part because it had had no prior experience with price regulation prior to 1994; and, even on a national level, pure price regulation plans (i.e., plans without earnings sharing) were relatively new. The Company argues that price regulation is now the rule, rather than the exception; that this proceeding provides ample opportunity to fine-tune any components of the Plan which did not meet the Commission's expectations; and that, given the time and resources which this proceeding has consumed, there should only be a second review proceeding if it proves to be necessary. AI argues that Section 13-506.1(e) provides the Commission and all parties ample authority to initiate or request an investigation if the Plan does not appear to be functioning properly in the future or if there are unexpected marketplace or economic developments. However, to facilitate the Commission's monitoring of the two key financial components of the index (i.e., GDPPI and the X factor), AI agrees to provide updated information and/or studies relative to these factors in 2007, at the time AI submits its annual price cap filing for 2006, at which point the Plan would have been in effect for another five-year period.

Staff and City/GCI, takes the position that the Commission should order all of the existing reporting and monitoring requirements be continued unchanged. In the absence of reporting and monitoring requirements, Staff contends that the Commission, the Staff, and the many parties with a legitimate interest in whether AI was complying with its obligations under the Plan would be unable to make an informed assessment. Staff also argues that all of the individual reporting requirements continue to be meaningful in a regulatory sense. Even where information may be duplicative, Staff contends that there should be a single complete source of information regarding AI's performance under the Plan. Staff also recommends that a schedule for the next review proceeding be specified in the Commission's Order in this proceeding.

Commission Analysis and Conclusion

The Commission concludes that the reporting requirements associated with this Plan should be retained. The Commission, Staff and other parties have a legitimate interest in determining whether AI is complying with its obligations under the Act. The information supplied by AI through the monitoring and reporting requirements is a critical tool for determining whether AI is complying with the conditions of the Alternative Regulation Plan. We acknowledge that in certain limited instances, reporting requirements may be duplicative. While we agree with AI that one of the statutory goals of alternative regulation is to reduce regulatory costs where practicable, we are persuaded by Staff's position that there should be a single complete source of information regarding Ameritech's performance under the plan.

H. One-Time Credits or Refunds

Staff's Position

Staff proposes two one-time credits or refunds be required as part of the Commission's final Order in this proceeding. First, Staff contends that a credit or refund is required to correct AI's use of an improper definition of irregular service installation. Staff objects to the inclusion of orders for vertical services in AI's reports relative to installation within five days, and contends that these reports should be limited to network access lines. Staff suggests that, because it disagreed with the manner in which AI has defined Installation Within Five Days, AI should retroactively be found to have missed that benchmark during previous years. As a result, Staff argues that the Commission should reduce AI's rates by $29.5 million. Second, Staff argues that $7.4 million should be flowed back to customers to correct for the improper re-classification of certain residential services as competitive, a classification which AI voluntarily withdrew in February of this year. Staff also argues that approximately $74 million should be flowed back to customers to correct for the improper re-classification of certain business services as competitive

AI's Response

AI opposed both refund proposals. With respect to Installation Within Five Days, AI contends that Staff's proposal is unreasonable because the Company has always reported its installation data including all new ("N"), transfer ("T") and change ("C") orders. Vertical service orders have generally been categorized as C orders. The Company pointed out that there is nothing inherently incorrect about this definition; in fact, it is the definition suggested by the language of a recent NARUC white paper on service quality measures. Even more importantly, AI argues that this is the way AI reported the data upon which the current Plan benchmark is based. Thus, had AI reported installation performance in the manner suggested by Staff, the benchmark would not be 95.44%. AI disputes Staff's and City/GCI's suggestion that vertical service orders would have been negligible during the benchmark years of 1990-91 as not supported by the record. AI contends that the vast majority of its vertical services were introduced between 1974 and 1989, which suggests that vertical service orders were likely quite significant by 1990.

AI also argues that Staff's proposal would be unlawful. The Commission has reviewed and approved each of AI's annual rate filings under the Plan, including the service quality adjustments in the Plan's PCI calculations. AI contends that to impose a rate adjustment now, based upon Staff's current view of the manner in which installation data should have been (but were not) reported in the past, would be fraught with both legal and policy implications, including violation of the prohibition against retroactive ratemaking. Since AI's rates were previously lawfully approved by the Commission, AI argues that to require a refund now would be unlawful. <u>Independent Voters of Illinois v. Commerce Commission</u>, 117 Ill. 2d 90, 95-98 (1987).

AI also opposes a refund/credit associated with the reclassification of certain residential services and business services which are the subject of Docket 98-0860. With respect to a credit for the residential services reclassification, AI states that Staff was not fully apprised of the relevant factual circumstances. After these services changed to competitive, AI explained that it made precisely the same reductions in their rates as it did in the rates of their noncompetitive counterparts. Therefore, AI claims there is no shortfall in the rate reductions that would otherwise have been required by the Plan. Moreover, AI contends these services have been incorporated in the Company's annual filing for calendar year 2000, which was submitted to the Commission on April 2, 2001 (administrative notice requested). AI argues that Staff's proposal would require the Company to reduce rates twice.

Commission Analysis and Conclusion

The Commission concludes that it will not adopt either of Staff's proposed one-time rate reduction or credit proposals. We agree with AI that it would be unreasonable to redefine the Installation Within 5 Days standard at this juncture and apply that definition retroactively to past reporting periods. The record demonstrates that AI has used its installation definition consistently since before the Plan was adopted and we therefore find no evidence of bad faith. With respect to the credit proposed by Staff for AI alleged premature reclassification of residential services, that issue is already properly before us in Docket 98-0860.

I. Improper Reclassification Penalties

GCI/City's Position

City/GCI proposes a new penalty plan to discourage what it viewed as premature competitive classifications. City/GCI argues that, in order for the refund provisions to be invoked whenever appropriate, the Commission must investigate every improper reclassification, an undertaking which City/GCI claims is impractical given the broad range of services that AI has classified as competitive, and the lengthy and complicated proceedings required for an investigation. Additionally, City/GCI contend that AI has cited administrative problems associated with paying refunds, which have resulted in delays in refund payments.

City/GCI propose that the Commission adopt new safeguards against improper reclassification. First, City/GCI propose that on a going forward basis, the alternative regulation plan provide for financial consequences of up to $10,000.00 per day for competitive reclassifications that are later found to be improper by the Commission. City'GCI's propose penalty would be in addition to any refund requirements applicable pursuant to the PUA. Second, City/GCI propose AI would be required to reclassify improperly classified services back to their noncompetitive status and reduce the rates of those services back to their pre-competitive reclassification level within five days of a Commission Order rejecting a competitive classification. Finally, City/GCI recommend that the Commission adopt an earnings sharing provision to reduce AI's incentive to prematurely reclassify services as competitive.

Staff's Position

Staff adopted the City/GCI proposal, arguing that incorporation of such a penalty would be sound, and in keeping with the purposes of the Plan. In Staff's view, such a penalty would discourage improper reclassification, and in turn would improve the effectiveness of the Plan. Moreover, in light of the fact that the Commission would, under the proposal, have considerable discretion to assess culpability for improper reclassifications, and reduce or remit any penalties based on such an assessment, the proposal should not be considered confiscatory or unreasonable.

AI's Response

AI opposes the improper reclassification penalty proposal. AI argues that reclassification penalties are unreasonable as a matter of regulatory policy. AI acknowledges that there has been an ongoing disagreement between itself, the Commission Staff and City/GCI as to how much competition is required to support a reclassification under Section 13-502(b). However, AI points out that the Commission will likely provide substantial guidance on this issue in its Order in the pending reclassification case (Docket 98-0860) and that a separate proceeding (Docket 98-0861) has been initiated to establish rules for such classifications. Thus, AI contends that the fact that the parties are currently at odds and the fact that Docket 98-0860 has proved to be lengthy and complex are not grounds for punishing AI. AI contends that it did not act illegally by declaring the services to be competitive and further contends there is no evidence in the record that AI has acted in bad faith. In fact, AI notes that more of its competitive classifications have been approved than rejected by the Commission over the last several years.

Furthermore, AI argues that nothing in the Act permits the Commission to impose penalties in this situation. AI asserts that the Commission's powers and authority are defined by the terms of the Public Utilities Act. <u>Business and Professional People for the Public Interest v. Commerce Commission</u>, 136 Ill. 2d 192, 201, 240 (1989). AI further asserts that the Commission's authority to impose penalties is limited by Sections 5-202 and 13-516. The sanctions found Sections 5-202 and 13-516 apply to conduct which violates specific provisions of the Act or specific orders or rules of the Commission. In AI's view, neither of the Sections would permit the imposition of additional penalties, just because the Commission disagrees with a service reclassification. In addition, AI contends the law disfavors penalties in the absence of demonstrable bad faith, intentional wrongdoing or other comparable conduct, as being violative of due process. <u>Southwestern Telegraph and Telephone Co. v. Danaher</u>, 238 U.S. 482, 489-490, 35 S.Ct. 886, 888 (1915). Furthermore, AI opines that Section 13-502(e) already provides mechanisms to ensure that the Company does not profit from, and customers are not harmed by, classifications that are later overturned, because the Commission has the authority to require that rates be returned to their pre-reclassification level and that any rate increases be refunded to customers.

Finally, AI contends that City/GCI's reclassification penalty proposal is outside the scope of this proceeding. AI asserts this proceeding was initiated to review the functioning of the Plan under Section 13-506.1 which has nothing to do with competitive service reclassifications, which are governed by Section 13-502.

Commission Analysis and Conclusion

The Commission rejects the improper reclassification penalty proposal advanced by City/GCI. We agree that our authority is limited to that which is presently expressed within the Public Utilities Act, specifically the refund provisions of Section 2-202, 13-502 (d) and the enforcement provisions of 13-515. Section 13-515(j) already provides a sanction mechanism, albeit significantly less than that proposed by City/CUB.

At first blush City/CUB's reclassification penalty provision would most certainly serve as a deterrent to the reclassification of non-competitive services. A thorough examination of the City/CUB proposal leads us to conclude however, that such a deterrent will impede the development of a competitive market place for telecommunication services by causing AI to be overcautious when reclassifying services. Should the City/CUB or Staff seek an amendment to the PUA, they should be mindful of the effect a penalty provision will have on the development of a competitive telecommunications marketplace. Finally, it is our expectation that the Orders in Dockets 98-0860 and 98-0861 will provide substantial clarification to the parties as to our interpretation of Section 13-502(b) and the evidence required to support a competitive classification and thus eliminate the perceived ambiguity which currently exists.

VI. RATE REINITIALIZATION

The GCI/City point to the Company's earnings and assert that AI should be permitted to earn only its authorized return on equity established at the outset of the Plan. They would have the Commission perform a traditional analysis and reset rates according to an authorized level of earnings.

To the extent that rate re-initialization is defined as reducing rates to the level that would result from a traditional rate case, Staff recommends that there be no rate re-initialization. In other words, Staff opposes reinitialization based on, or due to, AI's earnings under the Plan because it does not consider those earnings and associated rates to be unfair, unjust or unreasonable.

According to Staff, the parties favoring reinitialization judge the reasonableness of AI's rates solely by the level of its earnings. In doing so, they fail to recognize on any deep level that alternative regulation provides non-competitive service subscribers with a "guarantee" that their overall rates will rise less than general inflation while AI is only given the "opportunity" to earn higher returns. If AI succeeds in earning higher returns,

Staff notes that that is surely one of the possible outcomes that was to be expected. As such, it is not the basis for reinitialization.

In Staff's view, AI has earned well under the Plan primarily because it has been able to classify services as competitive when such effective competition did not actually exist. In doing so, it was able to raise prices for services out from under the cap. The remedy for this overreaching, Staff claims, is to move the services in question back into the non-competitive category.

Staff recommends that the Commission not reduce existing non-competitive rates in order to bring AI's earnings back to rate-of-return levels. Such action, Staff asserts, would lower the price of these services to below what would exist in competitive markets. The right thing to do, Staff maintains, is to reduce the prices of services that are returned to the non-competitive class back to what they were had they stayed under the Plan. (Staff Reply Brief at 27-28). According to Staff, the HEPO in Docket 98-0860, if adopted, sets out the appropriate end result. Staff expects that when that proceeding is ultimately completed, it will produce both a revenue reduction and a one-time refund to end users.

AI argues that rates should not be re-initialized. Such an action, it claims, is contrary to the principles of price regulation and would undermine the incentive to operate efficiently and invest in more risky technologies. AI further contends that the proposal to reinitialize rates on the basis of AI's financial performance during the single best Plan year, i.e., 1999, at a high economic period, ignores the reality of the changing economic climate during which competition and technological advances will be accelerating. AI maintains that its earnings over the initial review period of the Plan were impacted by three main factors:1) the superb economic environment; 2) the successful promotion of discretionary services; and 3) aggressive cost reductions. The Company also believes it unlikely that any of these conditions are sustainable.

Commission Analysis and Conclusion

In an earlier section of this Order, we observed that fair, just and reasonable rates are not necessarily a function of earnings under the Plan which has prices as its main focus. The GCI/City cannot seem to break away from the idea that earnings, such a integral part of ROR regulation, do not hold the same prominence under alternative regulation.

The GCI/City believe that the Commission is obligated to reinitialize the Company's rates, because it did just that in 1994. And, as in 1994, CUB and the AG have filed a rate relief complaint to that effect.

According to the GCI/City, the failure to reinitialize rates at the start of any new plan ensures that the going-in rates are not just and reasonable. Indeed, their arguments repeatedly refer to a “new” plan or the “establishment of a plan.” In all their contentions, the GCI/City fail to realize that this is not a” new “plan, and certainly not in the sense that our 1994 Order established a “new “ plan.

What was a rational and necessary move by the Commission at the initiation or the “establishment” of the Plan, when AI was still under ROR regulation, is not viable at this juncture where ROR has long been abandoned in favor of alternative regulation. This is underscored by the evidence showing that rates have declined under the Plan’s operation which means that the formula has worked to our expectations. Rate reinitialization on the basis of earnings might be realistic if those earnings were outside the zone of reasonableness. They are not.

To be sure, if the Commission was considering a switch to an entirely different type of plan, with a new and different set of components, the GCI/City position might have some validity. That, however, is not the case. Each and every one of the proposals before us addresses the Plan much as it is, with only relatively modest adjustments thereto. Thus, the attempt by the GCI/City to compare the Commission’s 1994 action in setting rates for the initiation of the Plan to the instant situation where we review the continuing operation of the Plan to make it better and more responsive, is unavailing.

There is no showing that rates are unfair, unjust or unreasonable through any type of reasoned analysis. We are only presented with the proposition that - earnings are higher than initially authorized and hence rates must be unreasonable. This is neither logical nor meritorious for present purposes.

Earnings under alternative regulation are the function of a completely different set of initiatives than earnings generated under traditional regulation and must be viewed in that context. An increase in earnings was not unexpected just as a reduction in rates was expected. In a period of high overall prosperity, as was the situation in the Plan’s initial term, that expectation level only increased.

Given all of the coming changes in the telecommunications marketplace and the variations in the economic climate, we do not see AI being able to manage either costs or earnings nearly as effectively in the next term.

The reinitialization of rates is very much a form of ROR regulation. As such, it is inconsistent with the principle of alternative regulation which puts the focus on prices and not on earnings. As Staff and AI observe and the evidence shows, reinitialization carries the potential for a number of material and far-reaching consequences. Notably, reinitialization may impact negatively on the growth of competition which is one of the alternative regulation goals to be considered under the Act.

In this instance, reinitialization proposal would effectively stop the Plan, rewind it under ROR regulation, and then run the Plan again. The irrationality of such a scheme is obvious. We reject the proposal. The CUB/AG complaint which is based on these same underlying assertions, also fails.

VII. SERVICE QUALITY - GOING FORWARD

A critical factor for determining whether to approve or continue with a Plan is whether it will operate to maintain the quality of telecommunications services. In the Alt Reg Order, the Commission was mindful of the potential inherent in alternative regulation to allow service quality to degrade. Indeed, in light of Ameritech Illinois' recent service quality failures, the Commission remains greatly concerned with this potential. Therefore, it is incumbent upon this Commission to ensure that the service quality measures, benchmarks, and incentives that we adopt will be viable in maintaining service quality going forward.

A. Existing Measures and Benchmarks

The Commission included eight (8) measures of service quality when it adopted the existing Plan in 1994. It set the associated benchmarks for these measures on the basis of actual, historical performance levels - with one exception. Because AI's historical performance for Out of Service Over 24 Hours ("OOS>24") generally fell short of the standard in the Commission's Part 730 rules Commission adopted the benchmark in those rules. (the 83 Ill. Admin. Code Part 730). That approach was found to be consistent with the statutory goal of maintaining service quality. (Alt Reg Order at. 58).

Staff sets out the existing service quality standards and benchmarks in the Plan:

Standard	Code Part 730 Benchmark	Alternative Regulation Benchmark
Percent of Installations Within 5 Days	90	95.44
Percent Out of Service Over 24 Hours	95	95.00
Trouble Reports per 100 Access Lines	6	2.66
Percent Dial Tone Within 3 Seconds	95	96.80
Operator Speed of Answer – Toll and Assistance (Seconds)	10	3.60
Operator Speed of Answer – Information (Seconds)	10	5.90
Operator Speed of Answer – Intercept	N/A	6.20
Trunk Groups Below Objecting (per year)	98%	4.50

B. New Proposals

Staff and AI Position

In this proceeding, Staff has proposed that the following service quality measures be included in the Alternative Regulation Plan:

(1) Installation Within Five Business Days,
(2) Trouble Reports per 100 Access Lines,
(3) Out of Service Over 24 Hours,
(4) Operator Speed of Answer—Toll, Assistance and Information,
(5) Repeat Repair Reports,
(6) Missed Repair Appointments,
(7) Missed Installation Appointments,
(8) Speed of Answer—Repair Office, and
(9) Speed of Answer—Business Office.
(10) Calls Answered

In summary form, Staff's proposal would call for: a) the elimination of three of the existing measures (Dial Tone Within Three Seconds; Operator Speed of Answer—Intercept; and Trunk Groups Below Objective) b) the retention of three of the existing measures (1-3, above); c) the combination of two of the existing measures (4, above); and d) the adoption of five new measures (5-10, above).

The Company generally agrees with Staff's proposed service quality measures, subject to a few concerns regarding the definition or calculation of some of the benchmark. Ameritech Illinois believes that Staff's proposed measures would, if appropriately defined and combined with appropriate benchmarks, satisfy the statutory goal of maintaining service quality.

GCI/City Position

The GCI/City Proposed that the following benchmarks be included in any alternative regulation plan approved by the Commission:

a.	POTS % installations within 5 days	95.44%
b.	Trouble reports per 100 access lines *	2.66%
c.	POTS % out of service for more than 24 hours *	5.0%
d.	Operator average speed of answer—toll and assistance *	3.6 seconds
e.	Operator average speed of answer—information *	5.9 seconds
f.	Operator average speed of answer—intercept *	6.2 seconds
g.	Trunk groups below objective *	4.5/year
h.	POTS % Out of Service Over 24 Hours	5.0%
i.	Average Speed of Answer	

- Residential Customer Call Centers 80% w/in 20 seconds

	• Business Customer Call Centers	80% w/in 20 second
	• Repair Centers	80% w/in 20 seconds
j.	% of Calls Answered	
	• Residential Customer Call Centers	95 %
	• Business Customer Call Centers	95 %
	• Repair Centers	95 %
k.	POTS Mean Installation Interval	4 business days
l.	POTS Mean Time to Repair	21 hours
m.	POTS % Installation Trouble Report Rate (7 days)	5%
n.	POTS % Repeat Trouble Report Rate (within 30 days)	10%
o.	POTS % Missed Installation Commitments – Company Reasons	1%
p.	POTS % Missed Repair Commitments – Company Reasons	1%
q.	POTS % Missed Installation Appointments – Company Reasons	1%
r.	POTS % Missed Repair Appointments – Company Reasons	1%

Under the GCI/City proposals: two of the existing measures would be eliminated; the remaining six measures would be retained, and ten more measures would be added. The GCI/City point out the differences between their proposals and those advanced by Staff. According to the GCI/City, their proposal adds only five measures to the four new measures proposed by Staff. The additional measures are all focused on POTS service: (1) POTS Mean Installation Interval, (2) POTS Mean Time to Repair, (3) POTS % Installation Trouble Rate (7 days), (4) POTS % Missed Installation Commitments —Company Reasons and (5) POTS % Missed Repair Commitments – Company Reasons. The only other difference between the proposals is that Staff would reduce more of the existing eight standards than GCI/City recommends and, that GCI/City witness TerKeurst proposes to disaggregate two measures, Average Speed of Answer at Business Offices and % Calls Completed at Business Offices, for residential and business customers to better monitor treatment of those customer classes.

C. Developing Benchmarks

Staff and the Company generally agree that the Commission should follow the same approach to developing benchmarks that it did in the 1994 Order. For most measures, this means that benchmarks will be based on actual, historical performance.

The primary differences between the Staff and Ameritech Illinois positions on benchmarks are: (1) what historical data to use in calculating the benchmark performance level, and (2) how to determine the benchmarks when only limited historical data are available or when available data reports below the standards announced in the Commission's Part 730 rules.

AI Position

Ameritech Illinois proposes to base new benchmarks on actual, historical data for the years 1994-99, whenever such data is available and assuming that the calculated performance level does not fall below a standard imposed by Part 730. According to AI, using five years of data fairly accounts for seasonal and year-to-year changes to produce the best available picture of the service quality levels to be maintained under the Plan.

Either Ameritech Illinois' or Staff's position would be reasonable the Company claims. Using five years of data has essentially the same purpose as eliminating the high and low data points: to moderate the impact of short-term fluctuations of the benchmarks. In AI's view, using the five years of data that it proposes, will better account for seasonal and year-to-year changes than would using two years of data.

As for new requirements, the limited data available for these measures does not establish a historical level of performance consistent with the new Part 730 rules. As a result, and to be consistent with the Alt Reg Order's treatment of another measure, i.e., 00S>24, Ameritech Illinois proposes benchmarks based on the standards in Part 730.

Staff Position

Staff also generally relies on historical performance data for calculating its proposed "new" benchmarks. It, however, opposes the use of a five-year average. Staff would use data for 1998-99, with the three highest and lowest data points eliminated. As Ms. Jackson testified, Staff's methodology is based on the one adopted by the Commission in the 1994 Order to calculate the Plan's existing benchmarks. Staff also notes that Ameritech considers the two-year approach to be "generally sound."

Further, Staff does not support recalculating the benchmarks for any existing service quality standards, except for the combination of the operator answer times. Staff accepts Ameritech's suggestion for a weighted average of the combination of operator answer times, if it was based on 1998 and 1999 data. (Tr. 2034 - 2035, 2041 - 2042).

AI argues that unlike the benchmarks which the Commission adopted in the 1994 Order, the GCI/City's proposed new benchmarks generally do not take into account actual, historical performance levels. Instead, AI claims, these new benchmarks are based on a smattering of internal performance targets and what Ms. TerKeurst described as "other" factors. The record, AI notes, contains no evidence that Ameritech Illinois or any other local exchange carrier has actually performed at levels sufficient to achieve those standards. Indeed, AI notes, Ms. TerKeurst conceded that she could not name a single carrier that has done so. (Tr. 2134).

GCI Position

GCI/City contend that the Company's proposal to set benchmarks based on average service quality performance over the last five years is inconsistent with Ameritech Illinois' recognition of its inadequate service quality performance during several of those years. For example, Mr. Hudzik conceded that IBT's performance for Average Speed of Answer declined significantly between 1997 and mid-1999. Mr. Hudzik also stated that AI's installation and repair performance was inadequate during 1999 and 2000 and that the Company has had problems keeping repair and installation appointments. The GCI/City believe that it is internally inconsistent for the Company to acknowledge some degradation in its service quality and then request that this degradation become the benchmark for evaluating whether service quality is maintained in the years to come.

The GCI would have the Commission adopt benchmarks based on pre-plan levels, taking into account any other relevant factors. In instances where pre-plan data is unavailable or otherwise inappropriate, GCI would have the Company's own internal targets be used. For those measures where the Company's performance during 1995-2000 is the only source available, the GCI/City contend that the benchmark should be based on the one year since the plan's inception that AI performance was best. To do as the Company and Staff recommend, the GCI/City claim, would lock in service quality standards at less-than-adequate levels.

Commission Analysis and Conclusion

Pursuant to Section 13-506.1, the Commission may approve the plan or modify the plan and authorize its implementation only if it finds, after notice and hearing, that the plan or modified plan at a minimum, will meet certain standards. In particular, we note that this Section provides that such implementation or modification "will maintain the quality and availability of telecommunications services". (220 ILCS 13/506.1(b)(6)).

The statutory directive that a Plan be approved only if it will "maintain" service quality suggests the question - relative to what standard? The objective as we see it, is to have the Company maintain service quality at an acceptable level. We believe that all parties agree with this concept. It is in the application thereof that parties begin to differ.

While the Commission prefers to establish benchmarks on a case-by case basis for each of the measures adopted, as a general proposition, we believe that using five years of data better accounts for year-to-year and seasonal variations in conditions that affect service quality performance. We take note that year 2000 data is not part of any of the benchmark calculations and this is appropriate.

For any measures where inadequate data exist, or for which the existing data does not establish a level of performance consistent with the Commission's Part 730 rules, it appears reasonable to adopt the standards in the Part 730 rules. To the extent that any such measures or benchmarks are subject to changes in the pending Part 730 rulemaking proceeding Docket 00-0596, compliance with the new standard would be expected when the new rules take effect.

As a general observation, the use of a company's internal targets (directed to its employees) does not strike us as an appropriate standard for setting regulatory benchmarks. The premises for the former do not translate into the sound premises for the latter. The misuse of such internal targets might well have a chilling effect on a company's business practices and regulators should tread lightly in these areas.

With these concepts in mind we turn to the various performance measure/benchmark proposals.

D. The Performance Measure and Benchmark Changes

1. **Proposed: Installation Within Five Business Days (Current) (Existing Benchmark - 95.44%)**

Supported by: AI, Staff and GCI

All parties agree that "Installation Within Five Business Days" (or seven calendar days) should remain as one of the service quality measures under the Plan. Both Staff and the GCI/City, however, contend that this measure should be redefined to exclude orders for vertical services.

Staff and the GCI/City contend that because the installation of vertical services is less time-consuming than installing new or additional access lines these events should not be counted in the measure. They note that vertical service orders have likely grown over time, such that the inclusion of these orders in installation data may mask additional service quality problems.

Ameritech Illinois maintains that it has always reported installation data in the same way it does today. Thus, the calculation of the existing benchmark included vertical service orders. To change the definition of the measure without adjusting the benchmark would, in effect, arbitrarily raise the standard of service reflected in the plan.

The Staff and GCI/City argue that no adjustment in the benchmark is needed, because vertical service orders would have been negligible at the time the current Plan was adopted. Ameritech Illinois, however, introduced tariff filings that demonstrated that vertical services were established long before the Plan was adopted and it contends that the vast majority of Ameritech Illinois' current vertical services were introduced between 1974 and 1989.

While Ameritech Illinois agrees that vertical services have generally grown in proportion to total installation orders, the record does not show how fast or how extensively they have grown. As a result, AI maintains, it is not possible to conclude that such orders would have been "negligible" prior to the adoption of the current Plan. Only limited data is available for installation orders excluding vertical services and it shows that Ameritech Illinois would not have consistently achieved the 90% standard. Ameritech Illinois believes that the Commission should apply the benchmark in the Part 730 rules (90%), as it did for OOS>24 in the 1994 Order.

According to the GCI/City, the evidence shows that (1) vertical service "installations" require nothing more than a computer entry by a customer service representative; (2) demand for these services has exploded over the course of the plan, particularly since the merger with SBC and the increased marketing of vertical services like Caller ID and others, and (3) the Company's ability to meet the standard increases dramatically when vertical services are included in the computation. The GCI/City note that Staff could find no other LEC in Illinois that, before or since the Plan, has computed this measure by including vertical service requests.

In short, the GCI/City maintain that the Commission should neither lower the applicable benchmark for this measure nor should it permit the Company to include the installation of vertical services in the computation of the standard. Staff agrees on both counts.

Commission Analysis and Conclusion

Adopted: Measure No. 1 - Installation Within Five Business Days
Benchmark - 90% with escalations to 95.44%

The measure for Installation Within Five Business Days is herewith defined to exclude orders that are limited to vertical services. Since the existing benchmark was calculated from data that included vertical services and we have no definitive evidence on the extent of the growth before or during the Plan term, however, we believe it fair to re-set the benchmark. Available data for the measure, as we here define it, does not establish a performance level consistent with the standard in our Part 730 rules i.e.,90%. Therefore, consistent with our treatment of OOS>24 in the 1994 Order, we will adopt the Part 730 standard as the benchmark for this measure. We will, however, require an escalation of 1% every 6 months until the benchmark reaches the desired

95.44%.

2. Proposed: Trouble Reports per 100 Access Lines (Current) (Existing Benchmark - 2.66)
Supported by: AI, Staff, and GCI

All parties favor retention of the existing measure and benchmark for Trouble Reports per 100 Access Lines.

Commission Analysis and Conclusions

Adopted: Measure No. 2 - Trouble Reports per 100 Access Lines Benchmark - 2.66

The Commission determines that the existing measure and benchmark will be retained.

3. **Proposed: Out of Service Over 24 Hours (“OOS>24”) (Current) (Existing benchmark - 5%)**
Supported by: AI, Staff, and GCI

All parties favor retention of the measure for OOS>24, along with the existing benchmark of five percent. The GCI/City, however, question whether Ameritech Illinois may have overstated “Act of God”, i.e., weather exclusions, by removing trouble reports attributable to unusually severe weather from the numerator, but not the denominator, in the OOS>24 calculation.

Ameritech Illinois maintains that its method of calculating weather exclusions is entirely consistent with past practice, and it is entirely appropriate. As Mr. Hudzik testified, Ameritech Illinois has calculated and reported its OOS>24 data consistently since well before the current Plan was adopted. He indicates that the exclusion of weather-related troubles from the denominator in the equation “would artificially reduce the total number of troubles, essentially implying that [the weather-related troubles] did not exist.” That would be inappropriate, as the additional troubles caused by weather remain a part of the workload. As a result, no change in Ameritech Illinois’ reporting for OOS>24 is appropriate. AI would have the Commission consider the issue in the pending Part 730 rulemaking proceeding.

It is irrelevant, the GCI/City claim, that the Company has been calculating the OOS>24 measure a certain way for a long time if the methodology is incorrect. There is no doubt, they contend, that excluding weather-related outages from the numerator (which represents the number of outages that exceeded 24 hours) and then dividing that number by a figure that represents the total of all outages (*including* weather-related outages) decreases the resulting OOS>24 percentage. AI’s methodology, which inappropriately underreports the extent to which the Company failed the OOS benchmark, is consistent with the economic incentives to calculate the OOS>24 measure in manner that minimizes penalties. The GCI/City ask the Commission to counter this incentive and adopt Ms. TerKeurst's recommendation to exclude outages associated with "acts of God" from the denominator, as they already are in the numerator.

Commission Analysis and Conclusion

Adopted : Measure No. 3 Out of Service Over 24 Hours (Benchmark - 95%)

The existing measure and benchmark will be retained. For the moment given the limited input, comparison and other analyses on this question , we will not require any change in the manner in which "Act of God" (weather) exclusions are calculated and reported. We will, however, address that very issue in Docket 00-0596. Hence, we direct Ameritech Illinois to calculate and report weather exclusions consistent with the outcome of that proceeding and as soon as new Part 730 rules become effective.

4. Proposed: Operator Speed of Answer—Toll, Assistance (Existing benchmark - 3.6 seconds)
and
Operator Speed of Answer, - Information (Current/Combined) (Existing benchmark - 5.9 seconds)
Combination supported by: AI, Staff with new benchmark 5.61 or 5.65. Opposed by: GCI

Staff proposes to combine the existing measures and benchmarks for Operator Speed of Answer—Toll and Assistance, and Operator Speed of Answer—Information. Staff witness Jackson testified that the existence of two standards for operator services is "unduly burdensome." (Staff Ex. 9.0, p. 26). Ameritech Illinois concurs with Staff's view that retaining separate benchmarks for the operator assistance measures would not be warranted, especially where Operator Speed of Answer has not been a problem since the adoption of the Plan.

The GCI/City oppose Staff's position based on witness TerKeurst's testimony that combining the measures may encourage Ameritech Illinois to increase the time taken to answer toll and assistance calls. It is undeniable, the GCI/City claim, that from a mathematical perspective combining the measures and benchmarks permits the Company to permit answer times for Toll and Assistance calls to lengthen. The GCI/City urge the Commission to retain the Operator Average Speed of Answer – Toll and Assistance, and Operator Average Speed of Answer – Information, measures and their corresponding benchmarks as separate service quality criteria.

According to AI, Ms. TerKeurst's position is speculative because there is no evidence that combining the existing measures would result in performance falling below appropriate levels. Indeed, Ameritech Illinois maintains, it has met the benchmarks for both Toll and Assistance and Information calls consistently and by increasing margins over the term of the Plan. (Staff Ex. 8.0, Attach. 8.01). Further, AI argues, any increases in answer times would be reflected in the overall average, so Ameritech Illinois' ability to prioritize one set of calls over the other would be very limited.

As to the benchmark for the combined measure, Ameritech Illinois calculated a weighted average of the existing benchmarks, using 1994-2000 data to compare the number of Information calls to the number of Toll and Assistance calls. The combined benchmark, based on that calculation, is 5.61 seconds. Staff agrees that a weighted average would most accurately determine the combined benchmark, but prefers a calculation on the basis of 1998-99 data. The combined benchmark, based on Staff's approach, is 5.65 seconds.

Commission Analysis and Conclusion

Adopted: Measure No. 4 - Operator Speed of Answer-Toll, Assistance and Information.
Benchmark - 5.65 seconds

The Commission accepts Staff's proposal to combine the two existing measures into a single measure. We reject GCI's suggestion that Staff's proposal would allow declining performance for one type of calls to offset improvements for another. We find no basis to support this concern. To the contrary, Ameritech Illinois has met the existing benchmarks consistently and by increasing margins throughout the life of the Plan. The benchmark for this measure is set at 5.65 seconds as Staff recommends.

5. Proposed: Repeat Trouble Rate Repair. (New)
(Benchmark not established)
Supported by: AI, Staff, and GCI/City

The parties agree that Repeat Trouble Rate Repair should be included among the service quality measures in the Alternative Regulation Plan. Repeat troubles are cases of trouble within 30 days after a previous trouble report at the same customer location. AI explains that repeat troubles do not necessarily reflect a repetition of the same type of problem.

Ameritech Illinois proposes that the Commission adopt a measure for Repeat Trouble Rate (Repair) only and it further proposes a benchmark of 13.92%, based on data from 1994-99.

Staff suggests a clarification to AI's definition of Repeat Trouble Rate as "cases of trouble within 30 days after a previous trouble report at the same location" to further specify " at the same location and on the same line." (Staff Reply Brief at 58). Staff also appears to recommend a measure and benchmark that would combine "installation" repeat troubles and "repair" repeat troubles. Its witness, Ms. Jackson, initially proposed a single measure for repeat repairs, which she identified as troubles "within 30 days" of previous trouble. In its Brief, however, Staff clarified that its proposed measure includes both installation and repair repeat trouble reports. Staff proposes a benchmark of 14% for its combined repair and installation repeat rate based on the 1998-99 data for Repeat Trouble Rate (Repair).

As AI witness Hudzik explained, however, the measure and benchmark described in Ms. Jackson's testimony represent only the repair repeat trouble rate. Installation repeats are captured by an entirely separate measure, which tracks trouble reports within 7 days (not 30) of installation. As a result, AI maintains, there is no way to combine the two measures.

The GCI/City propose that repeat reports for both installation and repair be included in the Plan and propose two separate measures, with a benchmark of 5% for installation repeats and 10% for repair repeats.

Ameritech Illinois opposes Staff's and GCI's proposals. Ameritech Illinois did not believe that repeat reports for either installation or repair need to be included in the Commission's service quality measures noting however, that customers are more sensitive to repair repeats, because they have already experienced one instance of trouble. If such a measure is to be adopted, Ameritech Illinois contends that the applicable penalty should be split between installation and repeat troubles, consistent with Staff's proposal for a single, combined benchmark. For "installation" repeats, Ameritech Illinois proposes a benchmark of 16.90%, based on data from 1996-99. Ameritech Illinois further notes that, if Staff's benchmark calculation methodology is to be adopted, the necessary monthly data for installation repeat reports for 1998-99 could be provided through a post-record data request. Those data are not currently in the record.

The Company opposes the benchmarks suggested by GCI/City for both repair and installation repeat reports. AI notes that the GCI/City's proposed "repair" repeat benchmark (10%) was based on the Company's internal performance target. That target, AI maintains, has seldom, if ever, been attained. In fact, ARMIS data shows that very few LECs have achieved repair repeat trouble rates of 10%. (Am. Ill. Ex. Cox Cross 7). And, AI maintains the GCI/City proposed "installation" repeat benchmark (5%) reflects the Company's performance for an entirely different measure, i.e., New Circuits Failed, which is clearly separate and distinct from the installation repeat rate.

The GCI/City recommends that AI's "internal" target level of 10 percent be adopted as a benchmark. According to the GCI/City, the 13.92% AI proposed benchmark relies on data taken *during* the plan. With no data available prior to 1995 there is no basis upon which to conclude that AI's performance between 1995 and 1999 is as good as it was prior to the adoption of the price cap plan. The Company's complaints that use of internal benchmarks is inappropriate because they are viewed as difficult objectives designed to stretch the capabilities of AI employees is not persuasive to GCI/City. According to the GCI/City, Mr. Hudzik testified that AI has met its own internal service quality benchmarks, and even modified them to a stricter level to inspire improved performance.

If the Commission, however, were to decide on a historical performance-type benchmark, the GCI/City contend that the Company's performance during the best year for which data is available – the 12.63 percent achieved in 1997 – should be adopted as an interim benchmark for this measure, with the Company's own internal benchmark of 10% phased in by the second year of the plan.

Commission Analysis and Conclusion

Adopted: Measure No. 5 Repeat Trouble Rate.
Benchmark - Installation (16.90%) Repair (13.92%)

We adopt Staff's proposal to include in the Plan a combined repeat trouble measure reflecting both installation and repair repeat rates. Because these measures are incompatible, however, we cannot blend the two benchmarks in the manner suggested by Staff. Instead, we will set separate benchmarks and we will divide the assigned penalty equally between them. We adopt Ameritech Illinois' proposed benchmark of 13.92% for Repeat Trouble Rate (Repair), based on 1994-99 data. We adopt Ameritech Illinois' proposed benchmark of 16.90% for Repeat Trouble Rate (Installation), based on data from 1996-99.

We reject GCI's proposed benchmarks. Once again, we remain unconvinced of the propriety of setting benchmarks based on internal targets especially where they are inconsistent with actual operating performance. In any event we are persuaded that, for Repeat Trouble Rate (Installation), GCI has relied upon the wrong internal target.

6. Proposed: Missed Installation Commitments. (New)
(No benchmark established)
Supported by: AI, Staff. GCI/City

The parties generally agree that some measure of missed installation commitments (or appointments) should be included in the Plan. The issues raised concern the appropriate definition and benchmark for the such measure.

AI notes that missed installation commitments or appointments measures are not currently in the Plan. For its own purposes, however, Ameritech Illinois tracks installation "commitments." AI explains that, a commitment is met when the necessary work is completed within the time committed to the customer. It does not track whether a technician appears at the customer's premises at a particular time as this type of event Ameritech Illinois would call an "appointment". AI informs us that data is available for all installation commitments (whether or not field visits were required) from 1996 to the present, and beginning in 2000, further separated out for those commitments requiring field visits. Ameritech Illinois proposes a benchmark of 2.08% for all commitments, based on actual, historical performance for the years 1996-99.

Staff accepts AI's definition of "Missed Repair Commitments" as a measure of whether a repair has been completed on time and including both field and non-field visits. Staff would clarify however, that "completed on time means the time committed to the customer and within the OOS>24 hour requirement. Once again, based on historical data for the years 1998-99, Staff recommends a benchmark of 6.4%.

The GCI/City propose that two, separate measures be adopted: one for missed installation "commitments" (which GCI equates with all commitments) and another for "appointments" (which GCI equates with field visits commitments). They proposed a benchmark of one percent for each of these measures, based on the Company's internal performance target for Missed Installation Commitments (All Commitments).

The GCI/City claim that the Company's own data provides support for Ms. TerKeurst's recommendation that the benchmark for % POTS Installation Commitments be set at 1%, i.e. AI's "internal" benchmark. Based on data in its NARUC report, the Company's POTS % of Missed Installation Commitments Due to Company Reasons ranged between about 1.18 percent and 1.72 percent in 2000. In the event that the Commission concludes that actual performance should be used for purposes of computing benchmarks, despite the absence of pre-plan data, the GCI/City contend that Ms. TerKeurst's alternative benchmark of 1.32 percent, based on year 1999 performance, should be adopted.

According to the GCI/City, Company witness Hudzik admitted that he had conducted no specific analysis to determine whether weather or economic conditions were particularly unusual in 1999 or any other year. (Tr. at 1837-1839.) Hence, if historical data taken during the life of the plan is used, the GCI/City claim, it should come from the one year in which performance for that measure was at its best in order to prevent a degradation of service quality under the new plan.

Ameritech Illinois argues that GCI's proposal is based on a fundamental misunderstanding of the measures it has proposed. Those measures do <u>not</u> track commitments requiring field visits separately from those that do not. Both the FCC and the NARUC data upon which GCI witness TerKeurst relies reflect total installation commitments, including both those that require field visits and those that do not. The <u>only</u> available data that separately track installation commitments requiring field visits are the data Ameritech Illinois began to provide to Staff in 2000.

Ameritech Illinois also argues that internal goals do not provide appropriate bases for benchmarks. Such goals do not reflect actual, historical performance and the adoption of such goals as regulatory requirements would have the effect of encouraging the Company to minimize its internal performance goals, rather than striving for excellence. Ameritech Illinois also notes that GCI applied the wrong internal target to this measure. The actual internal target for Missed Installation Commitments (Field Visit) was five percent, AI claims, not one percent.

AI considers Ms. TerKeurst's alternative best year of performance benchmarks as equally flawed. This of approach, AI maintains, reflects "exactly the type of picking and choosing that would clearly be inappropriate" for determining service quality benchmarks. Choosing the single best year for a benchmark fails to account for year-to-year variability in factors such as weather and economic conditions that can very substantially affect service quality data. AI witness Mr. Hudzik explained that "it is necessary to consider both enough data and a consistent pool of data, so that a full range of conditions is reflected in the resulting benchmarks."

Data is available for all installation commitments (whether or not field visits were required) from 1996 to the present, and separated out for commitments requiring field visits beginning in 2000. Ameritech Illinois proposed a benchmark of 2.08% Missed Installation Commitments, for all commitments, based on actual, historical performance for the years 1996-99. According to AI, no installation commitment data is currently available excluding vertical services. However, Part 730 of the Commission's rules AI contends, provides a benchmark of 90% for "regular service" commitments met. 83 Ill. Admin. Code § 730.540(c). Staff also supported that standard in the ongoing Part 730 review in Docket 00-0596. Therefore, if the Commission wishes to adopt a measure that would exclude vertical services, Ameritech Illinois advocates a benchmark of 90% installations to exclude vertical service orders, completed within the time committed. That benchmark, AI maintains, would be subject to any changes in the standard in the pending proceeding.

Based on historical data from 1998 and 1999, Staff proposes a benchmark of 6.2%, for Missed Installation Commitments (Field Visit). In the alternative, and again based on 1998-99 data, Staff proposed a benchmark of 1.4% for Missed Installation Commitments (All Commitments). (Staff Reply Brief at 57).

Commission Analysis and Conclusion

Adopted: Measure No. 6. Missed Installation Commitments
Benchmark - 90%

This is a new measure of performance. Consistent with our finding on the definition of Installation Within Five Business Days, the Commission defines "installation" in these premises to exclude orders limited to vertical services. The limited data available for this measure, under such definition, AI claims, does not establish a historical performance level consistent with the standard in our Part 730 rules. Those rules require that 90% of all "regular service" installations be completed within the time committed. See, 83 Ill. Admin. Code §730.540(c). As a result, we will adopt the standard in the Part 730 rules, again subject to any changes in that benchmark that may result from our review of the service quality rules in Docket 00-0596.

We question Staff's benchmark proposal of 6.2% and request clarification in its Exceptions Brief. We reject the GCI/City proposed measures and benchmarks for missed installation "commitments" and "appointments." It appears that GCI misunderstands the definitions of the measures upon which it bases its proposal. We also reject GCI's proposed benchmarks, which are based on internal Company service quality goals. We agree with Ameritech Illinois that internal stretch goals are not appropriate for use as regulatory benchmarks. As we noted several times, a company may want to and should be able to better employee performance without regulatory interference and misuse. It further appears that GCI has applied the wrong internal targets for these measures, even if internal targets were otherwise appropriate as benchmarks.

7. Proposed: Missed Repair Commitments (New) (No Benchmark established)
Supported by: AI, Staff, and GCI/City.

Staff's proposal to include a new measure and benchmark for Missed Repair Commitments raises issues similar to those for Missed Installation Commitments. Unlike installation commitments, however, data is separately available for repair commitments requiring field visits, back to 1995.

Ameritech Illinois concurs with Staff's proposed measure and, on the basis of its historical performance for the years 1995-99, recommends a benchmark of 9.58% for Missed Repair Commitments (Field Visit). Staff contends that "Missed Installation Commitments" should be defined as installation or transfer of plain old telephone (POTS) service, meaning no vertical services, and include both field and non-field visits, with the completion of work at a committed (field visit not required) or at an appointed (field visit required) time. (Staff Reply Brief at 57). According to Staff, AI evidence provides historical data for Missed Installation Appointments that includes field and non-field visits and excludes vertical services. On the basis of this data for the 1998 and 1999 historical period, Staff recommends a benchmark of 6.2%. (Staff Reply Brief at 58.)

The GCI/City propose a benchmark of one percent (1%) for Missed Repair Commitments based on Ameritech Illinois' own internal target for Missed Installation Commitments (All Commitments). In the alternative, they propose that performance for the single best year (6.35%) be applied as an "interim" benchmark, changing to one percent (1%) in the second year of the Plan. AI provided no data for this measure for years preceding the adoption of the price cap plan, and in the GCI/City's view, the Commission cannot be certain that adoption of a benchmark based on even the best year under alternative regulation will result in the maintenance, as opposed to the degradation, of service quality for this measure. It notes that the Company's internal target of 5% for this measure is markedly worse than its established target for Missed Installation Commitments. According to these Intervenors, this difference suggests that the Company places a higher priority on installing new service than repairing existing service.

AI again contends that internal targets do not provide appropriate service quality benchmarks under an Plan. Further, AI claims, Ms. TerKeurst erroneously applied the target for all installation commitments (whether or not a field visit is required) to repair commitments that require field visits. This, AI notes to be a complete mismatch. AI explains that the internal target for Missed Repair Commitments (Field Visit) actually was 5%, and not 1%—entirely consistent with the target for Missed Installation Commitments (Field Visit).

If the Commission concludes that a benchmark based on historical data should be adopted even in the absence of 1990-1994 data, the GCI/City recommend that the best year for which data is available, 6.35 percent achieved in 1999, be adopted as an interim benchmark, with the 1% target phased in by the second year of the plan.

Commission Analysis and Conclusions

Adopted: Measure No. 7. Missed Repair Commitment
Benchmark - 6.4%

The Commission adopts the proposed measure for repair commitments requiring field visits. That measure better reflects repair performance in the field and would exclude all (or virtually all) troubles affecting only vertical services. We adopt Staff's proposed benchmark of 6.4%, based on historical performance for 1998-1999.

We reject the GCI/City's proposed benchmark of one percent, which is based on the Company's internal performance target for Missed Installation Commitments (All Commitments). As noted earlier, we do not consider internal targets to be the appropriate source for setting regulatory benchmarks. Here, we further note that GCI has applied the wrong internal target.

8. Proposed: Average Speed of Answer—Repair (New)
(No benchmark established)
Supported by: AI, Staff, and GCI/City

The parties agree that answer time for repair offices should be included in the service quality measures in the Plan.

As for the benchmark, Ameritech Illinois proposes that the Commission adopt the newly effective Part 730 standard, i.e., an average of 60 seconds for all calls. The limited data available shows that while Ameritech Illinois has recently performed at a level consistent with the Part 730 benchmark, it has not yet done so consistently. Therefore, AI contends the 60-second average required by Part 730 should be applied.

Staff initially proposed that the Commission adopt a benchmark of 80% of calls answered within 20 seconds. In rebuttal testimony, however, Staff witness Jackson stated that she would reconsider her proposal in light of additional historical data to be provided by Ameritech Illinois. In its Reply Brief, Staff made clear that it now agrees with AI's proposal.

The GCI/City propose a standard of 80% answered within 20 seconds, based on the Company's internal performance target. Ameritech Illinois notes that GCI's proposal lacks either a historical performance record or a Commission rule to support it. As a result, it cannot be said to "maintain" any recognized level of performance, and it is therefore inconsistent with the Act and the 1994 Order.

The problem with the 60-second benchmark, the GCI/City claim, is that it relies on data derived *during* the price cap plan and thus, is not suitable for determining whether the plan will maintain service quality. While the Company's contends that use of internal benchmarks is inappropriate because these are difficult objectives designed to stretch the capabilities of IBT employees, the GCI/City are not persuaded. They assert that AI witness Hudzik testified that IBT has met its own internal service quality benchmarks, and even modified them to a stricter level to inspire improved performance. (Tr. 1842, 1856-1858).

If, however, the Commission determines that a historical standard should be used, the GCI/City recommend the adoption of a 45.8 second benchmark for repair centers, which represent the Company's best annual average performance during the life of the plan.

Commission Analysis and Conclusions

Adopted: Measure No. 8. Average Speed of Answer—Repair Benchmark -60 seconds

The Commission adopts a measure for Average Speed of Answer—Repair. We set a benchmark of 60 seconds average answer time for this measure as proposed by AI and supported by Staff.

9. **Proposed: Average Speed of Answer—Customer Calling Centers (new)**
(No Benchmark established)
Supported by: AI, Staff, and GCI

The parties agree that answer time for business offices should be included in the service quality measures in the Plan. Staff proposes and Ameritech Illinois agrees, that a single measure should be adopted to reflect both residence and business calling centers. The GCI/City, on the other hand, propose that separate answering time measures should be adopted for residential and business Customer Calling Centers.

AI contends that the GCI/City's proposal is inconsistent with the manner in which business office answering time is defined in Part 730. To be sure, AI claims, the Commission's rules provide a single, combined measure and benchmark for both residence and business Customer Calling Centers. (See, 83 Ill. Admin. Code § 730.510(c).) In addition, a single measure is fully adequate to track business office answering time. Adopting two measures would over-emphasize answering time in the context of the overall service quality component of the Plan. If both measures were to be adopted, AI proposes that the Commission split the relevant penalty between the two measures.

Ameritech Illinois proposes a benchmark of 60 seconds average answering time, consistent with the Part 730 rules and Staff agrees. The GCI/City would recommend a benchmark of 80% of calls answered within 20 seconds, based on an internal performance goal.

Commission Analysis and Conclusion

Adopted: Measure No. 9 Average Speed of Answer—Customer Calling Centers.
Benchmark - 60 seconds.

We adopt Staff's proposal to include in the Plan a measure for Average Speed of Answer—Customer Calling Centers. We see no compelling need to adopt separate standards for consumer and business calling centers, as GCI advocates. Our conclusion is consistent with the manner in which answer time is reported under our Part 730 rules, which do not require separate reporting for consumer and business centers.

We further establish a benchmark of 60 seconds average answer time, as proposed by Ameritech Illinois and Staff which is consistent with our Part 730 rules. As noted above, such a benchmark is appropriate in the absence of sufficient data establishing a historical performance level to exceed the Part 730 standard.

10. Proposed: Percent of Calls Answered (New)
Benchmark

The GCI/City propose to include three separate measures of calls answered (or, calls abandoned), for both residence and business Customer Calling Centers and for Repair Centers. Staff initially proposed two abandoned call measures, one for Customer Care Centers (Residence and Business combined) and another for Repair. AI contends that the Commission rejected Staff's proposal to include measures for abandoned calls in the Part 730 rules in Docket 98-0453. In that proceeding, the Commission concluded, "measurement of abandoned calls is imprecise and the Commission declines to impose a measurement of abandoned calls at this time." See, Order, Docket 98-0453 at 8 (Feb. 9, 2000).

Subsequently, Ms. Jackson agreed in her rebuttal testimony that the Commission should not adopt a measure for the percentage of calls answered or abandoned. She testified, “Staff is prepared to accept replacement of the abandon rate with an answering time standard.” (Staff Ex. 23, p. 13). She agreed that answer time data alone “will provide the Staff with the information needed” to monitor answering performance. In its Reply Brief, however, Staff proposes a standard for calls answered, similar to GCI’s proposal. Staff would also recommend a single, combined measure for business and repair office answering. (Staff Reply Brief at 60-61). Staff proposes a benchmark of 90% of calls answered for its combined measure.

The GCI/City contend that this measure would be very useful in identifying any trend in the percent of calls that are abandoned because of excessive delays in response time and Staff witness Cindy Jackson testified that AI data suggests that an increase in the average speed of answer results in an increase in the percent of calls abandoned by customers. Further, Company data shows that the percent of calls answered was markedly better for business than residential customer call centers. In short, the GCI/City claim, the Percent of Call Answered measure provides another indicator of AI’s accessibility and responsiveness to customer inquiries and service needs. Although the Company has a 90% target level as its own internal measure, a 95% level should be established as the benchmark for each of these three measures the GCI/City contend. Thus, its use as a standard could result in a degradation of service. Moreover, use of such a standard would be consistent with the Commission’s rationale for establishing a standard for the Company’s % Installation Within 5 Days measure that was above the standard in Part 730 of the Commission’s rules.

Commission Analysis and Conclusion

Adopted: Measure No. 10 Percent of Calls Answered Benchmark

The Hearing Examiners hereby direct the parties to better explain the measure, benchmark and their respective positions in their Exceptions.

Further Conclusions

The following provisions shall be eliminated from the Alternative Regulation Plan:

a. Proposed: Percent Dial Tone Within Three Seconds (Current)
Elimination Supported by: AI, Staff, and GCI/City

b. **Proposed: Operator Speed of Answer—Intercept**

(Current)
Elimination supported by: AI, Staff and GCI/City

c. Proposed: Trunk Groups Below Objective (Current)
Elimination supported by: AI, Staff and GCI/City

The Commission rejects the remaining proposed service quality measures. These proposed measures are largely duplicative, confusing and ill-defined for purposes of determining appropriate benchmarks. We do not find them to be useful.

E. Phase-In of New Benchmarks

Staff's Proposal

Both Staff and Ameritech Illinois agree that any new benchmarks should be phased in. Ameritech suggests that the new service quality standards be phased in over a three-year period, since they have not previously been regulatory requirements in Illinois. Staff proposes to set each new benchmark three percentage points below the relevant benchmark, with a one-percent increase every six months. This shorter time period, Staff claims, would allow consumers to receive the benefit of the new standards more quickly, and would provide Staff with more information for its analysis during the next review of the Plan.

Ameritech Illinois argues that Staff's proposed 18 month phase-in is too short to accommodate the necessary planning and budgeting. It further notes that changing the benchmarks every six months is inconsistent with the annual filing cycle for the Plan, which might cause interpretation and administrative problems for the Commission.

Commission Analysis and Conclusion

The Commission accepts Ameritech Illinois' proposal to phase in new benchmarks over three years. For each new benchmark adopted in this Order, the benchmark for the first year will be set two percent from the benchmark adopted, the benchmark in the second year will be set one percent from the benchmark adopted, and the benchmark in the third and subsequent years will be set at the benchmark adopted. We believe that a three-year phase-in will better coincide with both the Company's planning and budgeting cycle and with the Commission's annual review of the Plan.

F. Incentive Structure

AI's Position

AI proposes only one change to the Plan's service quality penalty structure. Currently, if the Company misses a service quality benchmark, a permanent 0.25% reduction of the PCI is required, even if it never misses that benchmark again. As a result, penalties for a single miss can accumulate far beyond the year in which the benchmark was missed. To correct this imbalance, AI proposes that the PCI be adjusted back upward when the Company subsequently achieves a benchmark that it had previously missed. According to AI, Ms. TerKeurst supported a similar proposal, when she testified on behalf of Staff in the Alt Reg Docket.

Staff Position

a. "Outside" the Price Index

Staff's primary recommendation is to remove the Q factor from the price index formula. As noted by Staff witness Staranczak, the penalties for failing to meet service quality benchmarks are too attenuated when filtered through the formula. Staff lists those deficiencies as follows:

- the deduction from the PCI results in penalties too small to provide adequate incentive to the company to meet the benchmarks;
- the deduction from the PCI provides inadequate incentive to the company to minimize its failures to meet benchmarks, i.e., if the company is going to miss the target, it may as well miss it by a mile;
- to be more effective, penalties should be incurred in closer proximity to the problem, rather than imposed up to a year after the fact, as occurs under the application of the PCI;
- the effect of the Q factor on the consumers' bill is miniscule and usually goes unnoticed;
- the penalty should be recast as compensation which is provided directly to those affected by poor service, where possible.

To satisfy these concerns, Staff believes the service quality incentives should be addressed outside of the price cap formula. Staff believes that, whenever possible, consumers who directly experience poor service quality should receive direct compensation. and particularly so, if service is not repaired within 24 hours or service was not installed within 5 days.

Staff proposes that one of two options be available if the Company misses installing telephone service within 5 days:

(1) a credit on the bill for a free installation and a $25 credit for each day the Company is late, e.g., day 6 -$25, day 7 -$50, day 8-$75, etc., or

(2) a credit for a free installation, plus a Company-provided cellular telephone with free activation and local service, until installation is complete.

In addition, Staff sets out two possible options for the Company's failure to repair a consumer's service within 24 hours.

(1) the Company would be required to provide an automatic $25 credit if the customer is out of service for 25-48 hours. The credit increases for greater periods out of service, would be as follows: 48-72 hours: $50; 72-96 hours: $75; 96-121 hours: $100 (with an additional $25 assessed for each 24 hours the customer is out of service);

(2) the other option would require a $25 credit plus a Company-provided cellular telephone with free activation and local service until the repair is complete.

Staff witness Jackson testified that it would be difficult to devise direct consumer compensation for the remaining service quality standards (i.e., operator answer time, trouble reports, abandon rate, repair and business office answer times, and repeat trouble reports (installation and repair)) as it would be difficult, if not impossible, to identify the harmed consumer. Therefore, Staff recommends a more generalized compensation for any failure to meet these standards. For any one of the six standards the Company fails to meet, Staff would have all customers receive a $2.25 credit on one monthly bill. The credit would apply for each standard and for each month that each standard is missed.

Staff notes that there is evidence on record showing that the Company would support direct consumer compensation for the benchmarks as long as the compensation levels reasonably equated to any rate reductions that would occur under the formula. (Tr. 676 - 679). According to Staff, Ameritech did not provide sufficient reason as to why such direct compensation should be tied to the price cap formula. As Staff notes many times over, the 'Q' factor rate reductions have proven to be insufficient incentive to Ameritech to provide adequate customer service. Ameritech has provided no basis for Staff or the Commission to believe that the Company's performance under this proposed standard would be any different.

b. "Inside" the Price Index

If the Commission chooses to keep the service quality indicator in the price cap formula, Staff recommends that the amount for OOS>24 and installations should be increased from .25% to 2% to provide the Company with the incentive to meet the minimum requirements. Staff also recommends that the remaining service quality standards and newly proposed standards should be given an equal weighting of .25%. Further, the Company would receive a score of zero for each of the benchmarks that it meets. Finally, Staff recommends that the rate reduction be returned to zero if the

Company met the benchmark for 12 consecutive months, not on an average of 12 months.

Staff notes that the distribution of .25% or $4 million per infraction over all of Ameritech's access lines only gave customers a credit of approximately 65 cents for each missed benchmark per month. Staff asserts that the consumer compensation offered by Ameritech for missing any of these benchmarks is not meaningful to customers. Moreover it has been clearly established Staff claims, that Ameritech has failed to adequately perform under the same level of penalty Ameritech proposes here. The one incentive level that seems to have attracted the Company's attention is the $30 million penalty imposed by the Commission in Docket 98-0555 – and, even then, the Company failed to meet the relevant standard. Thus, a higher level of penalties must be set for any extension of the Plan, if the Commission determines that the 'Q' factor should continue to operate. Therefore, Staff asks the Commission to accept its foregoing recommendations.

c. Additional Proposal

Staff testified to a third option, one based on graduated penalties, where each annual benchmark penalty would increase as the service quality declined. The Company's performance would be measured on a three-month average. A graduated penalty structure would provide the Company with an incentive to keep trying to meet the benchmark. Where there are capped penalties, and a longer, i.e., annual performance measure, and where the company knows it will fail to meet the benchmark, the Company might withdraw or minimize its efforts and resources until the following year, without incurring any additional consequences. In the meantime, however, customers would suffer from degrading service quality. Therefore, Staff recommends that, if the Commission adopts this option, - for the first 5% below the benchmark, the Company should be compelled to reduce rates by 2%. As service quality further declines in continuing 5% intervals - the rates should be decreased by 1.5% for each additional 5% decline in service quality.

GCI/City Position

a. "Outside" the Price Cap Index

The GCI/City believe that the service quality adjustment adopted in a modified plan should be administered separately from the price cap index so that the financial consequences of poor service quality are disassociated from AI's classification of services as competitive or non-competitive.

According to GCI/City, the service quality adjustment for failure to meet a benchmark should be set at $12 million per violation. Further, GCI would have the adjustment be increased depending upon (1) whether more than one violation has occurred, (2) the severity of the violation; and (3) whether there are violations in prior years. With such escalations, CUB claims, the Commission would eventually find the customer credit levels large enough to motivate the Company to correct service related problems.

If the Company violates more than one standard in any given year, GCI proposes that the service quality adjustment for each measure be added together for that year. The adjustment would also increase with the severity of the service quality degradation to avoid inadvertently having the Company "give up" on a standard if it appears that it will not be met in a given time period. The severity related factor reflects how far from the standard the Company performs. For example, if the standard is missed by 100%, the adjustment would be increased by 50%; if the standard is missed by 200%, the adjustment would be increased by 100%.

Under GCI's proposal, if AI were to continue to violate service quality standards year after year, the customer credit for that measure should be permanently increased by a factor of 1.5 each year. This escalation is necessary, GCI claims, because repeated violations demonstrate that the existing adjustment has not proved sufficient to incent the Company to make the needed service quality investment. Id. The escalation for repeated violations would be made irrespective of whether the Company violates the same or a different standard, and is necessary in light of AI witness Gebhardt's concession that AI has altered its dispatch of repair personnel in response to the Commission's service quality requirements. (An example of the calculation is provided in GCI/City Ex. 2.0 at 74-75).

GCI would have the full amount of the service quality adjustment be issued to ratepayers in a "one month" credit to customers of both AI's competitive and non-competitive services. The total credit would be allocated to retail consumers, carriers purchasing UNE, wholesale, interconnection and transport and termination services on the basis of gross revenues from each group. For retail and wholesale customers, the credit should be an equal amount per access line, and the other carriers should receive a credit on one month's bill.

b. "Inside" the Price Cap Index

For the service quality adjustment to the Price Cap Index (PCI) to be effective, GCI argues, it must be substantially more than the current .25% adjustment. By increasing the adjustment to 1.25%, as GCI proposes, the Company would be required to reduce rates by $13 million per violation, which is slightly more than what they are proposing for the adjustment outside the PCI. Similar escalations for severity of the service quality degradation, repeated and multiple violations to those proposed for adjustments outside the PCI should also be added to the formula. (The formulas and examples of calculations are included in GCI Ex. 2.0 at 77–78).

c. Additional Consumer Compensation

The GCI/City maintain that the credits to consumers who are "out of service" or who wait more than" 5 business days for installation" should be strengthened, and customer compensation should apply equally to consumers of services classified as competitive and non-competitive. In GCI's view, consumers of wholesale services, such as CLECs who provide local service through resale or UNEs, should also be entitled to compensation. Otherwise AI consumers would receive compensation for poor quality service, but CLECs and their customers would not receive equal treatment. This could have the unintended consequence of further degrading services to CLECs, and undermining the growth of competition, because AI may give higher priority to consumers for whom it is obligated to pay compensation than to CLEC customers.

The compensation scheme that GCI/City propose is as follows:

- POTS installation delayed beyond 7 calendar days or the day requested by the consumer, whichever is later: ($20.00 per 24 hours)
- Repair delayed beyond 24 hours after notice to Company, or missed repair commitment: ($50.00 per occurrence)
- Missed installation or repair appointments in absence of 24 hour notification: ($50.00 per occurrence)

The customer compensation credits for installation delays, according to GCI/City, should be automatic (not discretionary) and payable for each further 24-hour delay. In addition, the non-recurring installation charge should be waived, as is currently authorized by AI's tariff for private line service, when the installation interval exceeds Commission standards. The repair and missed commitments compensation would apply when consumers are left waiting for repair service after 24 hours or after a repair commitment made by the Company has expired. Finally, to incent the Company to honor its appointments with customers and to schedule appointments realistically, failure to keep an appointment should result in a $50.00 payment or credit to the consumer, unless the Company notifies the consumer 24 hours in advance. In addition to creating appropriate customer service incentives, this measure provides reasonable compensation to consumers who have lost time from work or otherwise managed their schedule to await a repair or installation appointment.

In addition to providing the above direct consumer compensation, the GCI/City would have AI establish a cellular telephone loaner program, so people who are without service can have telephone service available to them while they await installation or repair. And, because so many CLECs are resellers, and still dependent on AI for basic service connections and some repairs the GCI/City believe that this program should be available to wholesale as well as retail customers.

These direct customer compensation measures are necessary, the GCI/City maintain, to insure that the people inconvenienced by service quality degradation are compensated for the time they spend without telephone service, for the time and money they lose waiting for technicians who never appear, for the money they lose by having to obtain replacement service, for the money lost from missing work days or business calls, and for the increased risk associated with being unreachable when medical and other emergencies arise.

AI Response and Additional Proposal

AI asserts that Staff's proposal for handling service quality "outside" the price cap index is clearly excessive and punitive. It would impose a $13 million penalty for each month in which the Company missed a benchmark, for seven of Staff's ten proposed measures. The maximum penalty for each measure, AI claims, is nearly 40 times the penalty Staff proposes "inside" the price index.

AI witness Hudzik evaluated the likely impact of this proposal, assuming that Ameritech Illinois would perform at the same level it did in 1999, when it met all eight of the Commission's existing benchmarks. The evaluation showed that the non-customer specific penalty would total $351 million per year. In addition, Ameritech Illinois would pay significant customer-specific penalties. Such penalties would be completely unreasonable in light of the high quality of service provided in that year. Indeed, AI notes, Staff witness Jackson conceded that the likely penalties were higher than she anticipated when she developed Staff's proposal. (Tr. 2052-53).

According to AI, the enormity of the penalties is the result of two factors. First, because Staff's proposed credit of $2.25 would go to all customers, not just affected customers, the monthly penalties would be approximately $13 million per month. Second, by applying annually-based benchmarks to monthly performance, a significant number of monthly misses is virtually guaranteed, even if the Company performs at levels at or above the years in which the benchmarks were set. Indeed, Ms. Jackson conceded that her proposed monthly penalties are fundamentally inconsistent with Staff''s methodology for calculating benchmarks. That methodology is specifically intended to measure annual, not monthly, performance. (Tr. 2055).

AI maintains that the GCI/City proposals -- both "inside" and "outside" the price cap index -- are clearly unreasonable. Those penalty structure would increase the annual base penalty to approximately $12 million inside the price index and approximately $23 million outside the price index, coupled with a "multiplier" of 1.5 to be applied whenever the Company missed any service quality measures in consecutive years. The GCI proposals, AI claims, would result in annual penalties of hundreds of millions of dollars annually, and billions within the next five-year term of the Plan, even if service quality were maintained at excellent levels.

Mr. Hudzik evaluated the impact of the GCI proposals for addressing service quality "outside" the price index calculation. In his first scenario, he assumed actual performance levels from 1999 to the extent such data are available, and his best estimate of a reasonable 1999 performance level where actual data were not available. He also assumed that level of performance would continue over a five-year period. The results of Mr. Hudzik's evaluation showed that even if the Company matched its excellent 1999 performance, it would incur a penalty of $288 million in the first year of the new structure, escalating to $1.45 billion by the fifth year, with a five-year total of $3.8 billion. This number does not even include the credits which would have been paid to customers for missed installation and repair appointments under the GCI/City Plan. The GCI/City's proposal for addressing service quality "within" the price cap index is equally unreasonable AI claims.

AI notes that both Staff and the GCI/City would prefer that service quality be removed from the price cap index and penalties imposed in the form of customer credits, rather than revenue reductions. In principle, Ameritech Illinois does not oppose removing service quality from the price index calculation, nor does it oppose customer-specific credits, to the extent the Company's records are sufficient to determine which customers have been affected by service problems. The Company argues, however, that certain aspects of both Staff and GCI/City proposals for addressing service quality outside the price index render those proposals unreasonable and punitive.

With respect to 00S>24, Ameritech Illinois argues that its conduct since 1999 demonstrates that the existing penalties (including the $30 million merger penalty) are adequate to maintain reasonable performance. As shown by the very significant improvement in 00S>24 performance since 1998, the existing incentives have been adequate to insure the Company strives to meet the benchmark. Moreover, Ameritech Illinois asserts, the problems experienced in the latter half of 2000 have been addressed by force additions in the Network organization. These force additions demonstrate a strong commitment by the Company to deliver the required level of service.

Ameritech Illinois also opposes Staff's proposal to increase the penalty for Installation Within Five Days. The Company emphasize that it had always reported this measure in the same way, consistent with the manner used when the original benchmark was developed, and it has met this measure on a consistent basis. Ameritech Illinois does not object to redefining this benchmark. But, to penalize the Company when it has <u>never</u> missed the current benchmark, would be unfair.

The Company argues that the lack of proportionality between Staff's proposals "inside" and "outside" the price index is, by itself, strong evidence that Staff's "outside the cap" proposal is unreasonable. Ameritech Illinois and the GCI agreed that the financial impact of the Plan's service quality component should be approximately equal, whether service quality is addressed inside or outside the price index. Staff's explanation for the difference was that the proposed credits, if reduced to an amount equivalent to the current penalties, would not be meaningful to customers. Ameritech Illinois contends that the key question is not whether a penalty is "meaningful" to customers, it is whether the penalty is adequate to maintain performance at an appropriate level. Ms. TerKeurst testified that the goal should be to determine and establish financial consequences that are sufficient to ensure that Ameritech Illinois complies with the adopted standards.

AI Response - "Outside" the Price Index

While Ameritech Illinois does not object to the idea of flowing service quality incentives back to affected customers, it states that customer compensation per se is not the goal of an alternative regulation plan. Instead, as GCI recognized, that goal is to provide the level of incentive necessary to maintain service quality at an appropriate "going in" level. Assuming the Commission's penalties are adequate, providing additional compensation would amount to a double penalty.

AI notes that both Staff and GCI would impose customer-specific credits with no regard to whether the Company met the service quality benchmarks in the Plan. The Company argues that this is also inappropriate. In Staff's case, Ameritech Illinois explains, the proposal is inconsistent with Ms. Jackson's direct testimony, wherein she recognized that credits should be tied to benchmark performance. It is also inconsistent with the concept of maintaining service at benchmark levels. If all customers receive credits regardless of service levels, AI asserts, the benchmarks are meaningless. The idea of requiring credits without regard for performance levels, is equivalent to requiring perfect or 100% performance. This, AI contends, is inconsistent with the Public Utility Act, which requires "reasonable" service, not perfect service. 220 ILCS 5/9-201. "Reasonable service to all customers does not contemplate a perfect service free of problems . . ." Domestic Utility Services Co., Ill. C.C. Dkt. 81-0515, 1982 PUC LEXIS 10, p. *9 (Nov. 18, 1982).

Ameritech Illinois notes that it is possible to maintain a record of customers that have been affected by installation and repair delays and by missed installation and repair appointments. (Tr. 1967-68). Therefore, customer-specific credits can, in fact, be conditioned on whether the Company meets the relevant benchmarks and paid to the appropriate customers once the year's service quality data are available.

Ameritech Illinois further notes that the Staff and GCI/City's proposed customer credits for installation and repair delays are excessive, as they are not capped at a level that reasonably approximates the value of the service to be provided. For example, if Staff's proposed $25 per day penalty were applied, without a cap, to a situation in which a customer that experience an extended installation delay as a result of a lack of facilities in the area, the penalty would total $750 over 30 days--far in excess of the value of service (or the cost of obtaining replacement service). In the Company's view, this would create a windfall, not reasonable compensation. Both as a matter of regulatory law and as a matter of general commercial law, AI maintains, compensation should be limited to the value of service. In re Illinois Bell Switching Station Litigation, 161 Ill. 2d 233 (1994). To be sure, Ameritech Illinois observes, the ComEd credit program that Ms. Jackson cites as an example is capped at $100, which reasonably approximates the value of service.

If service quality is removed from the price index calculation, Ameritech Illinois proposes the following customer-specific credits, which are essentially the same as those currently in place in Ohio:

For 00S>24 misses:

- OOS reports lasting from 24 hours to 48 hours: a pro rata share of the customer's monthly regulated service
- OOS reports lasting from 48 hours to 72 hours: a credit equal to one-third of the customer's monthly regulated service
- OOS reports lasting 72 hours to 96 hours: a credit equal to two-thirds of the customer's monthly regulated service
- OOS reports lasting in excess of 96 hours: a credit equal to one month of the customer's regulated service

For Installation Within Five Days misses:

- Installations completed within six to nine business days: One-half of the non-recurring installation charges associated with the order
- Installations completed in 10 or more business days: 100% of the non-recurring installation charges associated with the order

Finally, Ameritech Illinois opposes any requirement that cellular telephone loaners be provided in cases of installation delay. As Mr. Hudzik explained, customers that experience installation delays are not paying for service during the delay and therefore need not be compensated for lost service. Moreover, they will typically have an opportunity to make alternative arrangements for service in the interim. So too, cellular telephone loaner programs impose significant expenses and administrative burdens. Thus, Ameritech Illinois argues their use should be minimized whenever other means of customer compensation are available.

Commission Analysis and Conclusion

In continuing with the Plan, we regard the Company's specific performance of its service quality obligations as our preeminent goal. To further this objective, the Commission must assign certain incentives to the Plan so that service quality is maintained pursuant to the mandate of Section 13-506.1 of the Act.

Our aim is to promote efficient investment in compliance. In other words, if service quality failure is a manpower problem, AI needs to ensure that its employee levels are sufficient to meet workload demands. If there are network deficiencies, AI must invest the necessary funds to correct any ill-functioning systems. In each instance, an expenditure of monies is at the heart of the solution. The choice we provide to the Company is whether it will spend the amounts required to maintain service at reasonable levels or whether it will forfeit the money in credits to customers.

It is the primary recommendation of both Staff and the GCI/City that the Commission remove the Q factor from the Price Index formula. We agree with those proposals. Further, the Commission is interested in moving the credits to those customers directly affected by service quality failures to the extent possible.

Any one of the incentive and customer compensation schemes we reviewed, however, would effectively absorb the penalties through administrative costs (which in fairness should be counted). Further, these proposals set out a number of schemes in a general fashion without sufficient explanation of the details for implementation or the cost and effort involved. For example, the record gives no tally of the total financial cost and administrative tasks associated with a cellular loan program or the abuse potential. It is one thing to propose what appears to be an attractive option. It is an entirely different thing to substantiate the inner workings, the costs, efficiency, potential abuse and the legal pitfalls of such a program.

In our view, as with most things, the simpler the better for all concerned. We recognize and appreciate that Staff has set out a number of goals, all of which it attempts to satisfy through its proposal. The objective, however, is not to create the perfect penalty to fit each and every conceivable situation. To the contrary, the objective is to set a reasonable penalty for the infraction that is direct, meaningful to both the customer and the Company, easily administered and in keeping with sound legal principles. In our view, penalties gain no value from being complicated - that would just engender a new set of frustrations for the public and create a new set of obligations on the Company.

In examining our work so far, we have adopted a number of performance measures and annual benchmarks have been set. This done, we consider it folly to impose penalties on monthly performance when benchmarks are derived on an annual basis. Indeed, no party proposed monthly benchmarks or explained the viability of using same. AI is also right to note that the incentives we set out must be assigned in relation to the annual benchmarks and not under a standard of perfect or 100% performance such as a monthly assessment would impose. These are critical factors we must keep in mind.

Generally, penalties are paid to a single entity, and usually in one set amount. Under the current proposals, penalties would be distributed as credits to customers. The reality is that all the proposals are forms of compensation. We first resolve the question as to who should be the recipient of the penalty credits.

We recognize that the standards of service are not all equal. Both Staff and the GCI/City tell us that Installation and Repair are the main components of telephone service. Indeed, Staff singles out these measures as worthy of enhanced penalties and attention under both of its proposals. Notably, AI informs us that it is possible to maintain records of the customers affected by installation and repair delays and by missed installation and repair appointments. On this basis, it is reasonable to distribute credits for these particular infractions to the actual aggrieved parties. This will be done.

A penalty is a penalty. The company is likely to be indifferent as to whom it is paid or credited. For the individual customer, however, it matters a great deal. Moreover, as the Company keeps track of its affected customers, it will be constantly reminded of the risk of penalty if it cannot meet the annual benchmark. This itself is an incentive for the Company to improve performance in the each of the following months.

With respect to the Company's failure to meet the benchmarks on other measures are here aggrieved customers cannot be easily tracked, the penalty credits would be distributed among all of AI's noncompetitive customers. The question remains whether the per aggrieved customer amount reasonably approximates the value of service denied or whether it meets Staff's concern that it be meaningful. To the extent that only affected customers, suffering the worst inconvenience share in the penalty, it is more likely than not that the credits will be meaningful as well as equitable. Those customers that are less inconvenienced will reap lesser credits and that, too, is altogether reasonable.

We are lead to the ultimate question, i.e., what is to be the penalty for the infraction. The penalty incentive for violations of a particular standard in our view should equal the amount of money to be spent on compliance efforts in order to signal the importance of the obligation and the seriousness by which it should be perceived. We, however, do not have such particulars. After much thought and full review of the proposals before us, the Commission settles on a penalty structure that is reasonable, realistic and geared to send the right signal on compliance.

We will set an amount of $8 million for each failure to meet the "annual" benchmark. This amount will rise by another $2 million each year of the plan. Our starting level recognizes that the oft-cited $4 million penalty in the Plan's initial term was not meaningful enough and thus, must at least be doubled. The escalation in penalties gives the Company the notice and opportunity to make the necessary investments where and how needed beginning today so that it can avoid the risk of non-compliance, i.e. the penalty.

Penalty Illustration

Year 2001	$ 8 million
Year 2002	$10 million
Year 2003	$12 million
Year 2004	$14 million
Year 2005	$16 million

In addition, if a particular benchmark is not met by more than 5%, or if the same benchmark was also not met in a previous year, an additional $2 million will be added. Further, if a benchmark is not met by more than 10%, still another 2 million will be added.

The OSS>24 hrs. performance measure is a special case. It has, and continues to warrant special attention. Hence, for this measure alone, the penalty incentive will continue at the $30 million amount originally set in the merger Order, Docket 98-0555. We take notice of our order in that docket and the basis for our setting on such amount, i.e., that it is the last sum equated with meeting compliance with this service obligation.

The Commission rejects the Staff and GCI/City compensation schemes because an immediate and automatic monthly credit such as they propose would void the benchmarks altogether and require "perfect performance" - a standard that is simply not supportable.

That said, we cannot discount the possibility of situations so egregious that even this benchmark irregularity will need to be tolerated. Thus, in instances where a customer waits for installation more than 2 extra days or is out-of-service for 48 hours or more, we direct Ameritech to provide on the next bill, the customer credits as specified in its proposal, to wit:

For 00S>24 misses:

- OOS reports lasting from 48 hours to 72 hours: a credit equal to one-third of the customer's monthly regulated service
- OOS reports lasting 72 hours to 96 hours: a credit equal to two-thirds of the customer's monthly regulated service
- OOS reports lasting in excess of 96 hours: a credit equal to one month of the customer's regulated service

For Installation Within Five Days misses:

- Installations completed within seven to nine business days: One-half of the non-recurring installation charges associated with the order
- Installations completed in 10 or more business days: 100% of the non-recurring installation charges associated with the order

In fairness, and to avoid a double penalty, if AI meets the benchmark, for these measures at the end of the year, it can deduct those credits and reasonable administrative costs from any other penalty amounts it might otherwise owe. And if it fails the benchmarks, it may also deduct the credits and reasonable costs from the penalty assessed.

In closing out this section of our Order, we remind AI that nothing is expected of the Company only that it work to maintain service quality at the required levels.

G. Other Service Quality Issues

1. Reporting

GCI/City Position

The GCI/City maintain that AI serves 85% of the access lines in Illinois, and includes in its service territory the Chicago metropolitan area as well as smaller cities in central and southern Illinois and it internally monitors service quality performance in each of 12 geographic areas in Illinois, and a review of that data shows significant variation. In order for the Commission and the public to insure that all citizens of Illinois are receiving quality service, and that no geographic area or customer class is receiving unduly worse service than others, the GCI/City would have AI report on all of the performance measures for business and residential services separately, and for each of the twelve geographic areas of the state. These reports they claim, can validate or undermine customer complaints, and enable the Commission to act promptly when service quality problems arise for a particular area.

The GCI/City proposes that this information be available to the public at AI's website, and be submitted to the Commission in a form suitable for posting on the Commission's website to enable interested parties to obtain the information with minimal administrative burdens.

Staff's Position

Staff claims that it has been hindered in its review of the existing Alternative Regulation Plan because of the lack of adequate company information needed to perform its review of the Plan. Accordingly, Staff recommends that the Commission require that the Company maintain adequate records to enable a thorough five-year review of the Plan by Staff and the Intervenors in the future. In order to facilitate the monitoring of the Company's compliance with service quality requirements, Staff recommends that Ameritech be required to:

(1) continue its filing of monthly service quality standard and benchmark reports with the Commission;

(2) provide an annual service quality report to all consumers;
(3) notify customers of any rate that changes (increases or decreases) brought about through the operation of the Alternative Regulation Plan.

AI's Position

Ameritech Illinois opposes the GCI/City proposal for additional reporting requirements. GCI/City's proposal requires that each one of its proposed service quality measures be reported monthly, that each be reported separately for business and residence, that each be reported separately by each of 12 geographic areas in Illinois, and that each be reported separately for single versus multiple lines. According to AI, the data sought is currently maintained in a multitude of separate data bases and is not being reported on a regular basis, either internally or externally. Thus, AI claims the GCI proposal would create a significant administrative burden. In any event, should the Commission desire any information beyond what is currently being reported, it is free to request that information. The Company should not be required to report such extensive and detailed data simply on the possibility that it might at some later date be needed for analysis. We also believe that the data would be of little use to consumers, as it is far too technical and detailed.

We are not persuaded of any necessity for imposing the reporting requirement that the GCI/City suggest or in the manner they propose. We agree with Ameritech Illinois that GCI's proposal would be unduly burdensome and would provide more detailed information than either a consumer or the Commission would normally require. As Ameritech Illinois is well aware, the Commission can always request additional information it claims necessary. AI, however, will be required to company with Staff's reporting recommendations. And Staff should not wait to inform AI of any reports it might need or desire for future reviews.

2. Investment

AI's Position

The Company further opposes the GCI proposal to require a minimum investment of $29 per access line in the "cable and wire" account. At the outset, AI notes that the service metrics which are currently in place provide the best gauge of whether or not the Company's investment levels are appropriate. If it is able to meet the established repair and installation objectives, the investment levels are appropriate. Further, the use of a fixed investment per access line ignores changes in the costs of network construction and maintenance. Should new technologies be more cost effective than previous technologies, the Company argues, it would lose the incentive to utilize these lower cost, more efficient investment alternatives.

Ameritech Illinois also contends that Ms. TerKeurst failed to provide any independent analysis to support her $29 figure, except to note that it represents approximately the amount Ameritech Illinois spent in that account in 1996. The mere fact that Ameritech Illinois spent a certain amount in the past, it claims, proves nothing about what should be spent today or tomorrow. The Company claims that Ms. TerKeurst also failed to explain the particular focus on the "wire and cable" account. According to AI, It is only one of many accounts that would affect network performance, but Ms. TerKeurst has completely ignored the other relevant accounts.

Finally, the Company emphasized that it has substantially increased network expenditures on its own, without any regulatory requirement that it do so. Comparing 1999 spending levels with 2000 and 2001 (estimated budget) levels, both capital and expense spending have increased very significantly. Capital investments in Illinois have increased from $787 million in 1999, to $918 million in 2000, and $1.043 billion (estimated budget) in 2001. Similarly, expenses have increased from $495 million in 1999, to $664 million in 2000, and to more than $798 million (estimated budget, excluding network planning and engineering) in 2001. The increases include service quality improvements, as well as other network initiatives such as Project Pronto.

Commission Analysis and Conclusion

We reject GCI/City's proposal to have Ameritech Illinois invest at least $29 per access line annually, in the "Wire and Cable" account. The GCI/City has not established that this level of spending is reasonable or appropriate on a forward-looking basis. It simply reflects the amount which Ameritech Illinois spent in 1996. Nor has GCI established that the particular "Wire and Cable" account is any more relevant to service quality than any of the other Plant in Service accounts. Finally, a capital spending requirement is inconsistent with the nature of alternative regulation. The Commission has adopted service quality measures and benchmarks that will assure adequate service quality in the future. What is required to have Ameritech Illinois achieve the mandated level of service is a decision best left to the Company. It will either rise or fall on the basis of such decisions.

3. Service Quality- Wholesale

McLeod Position

McLeod's sole concern in this proceeding relates to the service quality measures that Ameritech is required to meet as a component of its alternative regulation plan. As a competitive local exchange company ("CLEC") which is dependant upon Ameritech for substantially all of the facilities and services it uses to provide services to retail customers, it has a strong interest in the quality of service that Ameritech provides, and in whether Ameritech meets the performance measurement standards that this Commission has established.

It is McLeodUSA's position that such measures should incorporate *wholesale* performance measures, and that such component of the plan would adopt the concept of "parity with a floor" in establishing Ameritech's service quality standards. McLeod's position is that the wholesale performance measures component of the plan should remain in effect as long as alternative regulation exists for Ameritech. Specifically, McLeod agrees with Staff's recommendation that the wholesale performance measures and remedy plan that are adopted in the Condition 30 proceeding (Docket 01-0120) should be incorporated into Ameritech's alternative regulation plan, and should continue in effect for the duration of the plan.

McLeod contends that improving Ameritech's retail service quality is necessary for the development of competition in the telecommunications marketplace in Illinois. Ameritech has consistently advocated that it only has to provide service to wholesale customers that is equal to the service provided to retail customers. Mcleod stated that Ameritech's retail service quality is so inadequate, however, that it gives Ameritech a competitive advantage. McLeod states that poor wholesale service, even at parity with Ameritech's retail performance, can harm a CLEC in at least four ways: (1) it often delays the CLEC's ability to recover its costs because the CLEC cannot bill a customer for services it does not deliver while waiting for Ameritech to install or repair its lines; (2) it imposes additional personnel costs on the CLEC such as costs expended on staffing needed to deal with angry customers, as well as staffing needed to work through the ILEC escalation process to resolve the service problem; (3) it exposes the CLEC to potential liability for harm to the CLEC's customer, posing a significant financial hardship to CLECs, such as McLeod who are already incurring large capital costs associated with competitive entry; and (4) it can seriously damage the CLEC's reputation which in turn can thwart a new competitor's ability to gain a foothold in local markets.

It is McLeod's position that the Commission should adopt the concept of "parity with a floor" in establishing standards of service quality that Ameritech should be required to meet for the provision of services and facilities to both its retail and its wholesale customers. McLeod explains that "parity with a floor" refers to two things. First, it means that Ameritech should provide wholesale service to its competitors, such as McLeodUSA, at a quality level no worse than the level Ameritech provides to its retail customers -- i.e. "parity." Second, it means that Ameritech must meet or exceed an objective standard of quality for all of its customers, both retail and wholesale -- i.e. the "floor." The "floor", McCloud explains is the measure of service quality below which Ameritech's services must not be allowed to fall.

McLeodUSA agrees with Staff's recommendation that ***wholesale*** performance measures should be included in any extension of alternative regulation for Ameritech, and that the wholesale performance measures component of the plan should remain in effect as long as alternative regulation is in effect for Ameritech.

To ensure the quality of Ameritech's wholesale services and to ensure compliance with Section 13-506.1 of the Illinois Public Utilities Act, McCloud would have all performance measurements and the Remedy Plan adopted pursuant to Condition 30 of our Merger Order in ICC Docket No. 98-0555 be incorporated into, and continue without interruption, throughout the life of the alternative regulation plan.

Staff's Position

Staff recommends wholesale performance measures be included in this proceeding so as to survive the three year time limit of Condition 30 in Docket 98-0555. While the issue of a remedy plan remains contentious, Staff contends that Condition 30 has been a successful collaborative venture between Ameritech Illinois, CLECs, and Staff. The problem, from Staff's perspective, is that Condition 30 might be in effect only through 2002. In Docket 98-0555, the Order states:

> Except where other termination dates are specifically established, all conditions set out below shall cease to be effective and shall no longer be binding in any respect three years after the Merger Closing Date. (Order, p. 237).

While there is other language in the merger Order that may arguably indicate that Condition 30 does not end three years after the Merger Closing Date, Staff believes the Commission has an opportunity in this proceeding to prevent any potential misunderstanding in the future.

Hence, Staff recommends that the Commission institute a wholesale service quality plan that would start in October 2002, clearly surviving the "three years after Merger Closing Date" limitation that may apply to Condition 30. The wholesale service quality plan Staff recommends would use the same business rules and remedy plans for key measurements as defined and modified by the Condition 30 collaborative effort and any resulting formal proceedings.

Staff believes the wholesale performance measure plan should remain in effect as long as Ameritech Illinois has an alternative regulation plan, and as long as it is necessary for this Commission to ascertain that Ameritech Illinois is no longer able to provide discriminatory service to CLECs. Staff also proposes that, for this extension of the Plan, the Commission accept the penalty cap that is adopted in Docket 01-0120, the formal proceeding addressing the remedy plan from the Condition 30 effort.

AI Response

Staff and McLeodUSA contend that the Commission should address wholesale service quality in this proceeding by ordering that the provisions of Merger Condition 30 survive as part of the Alternative Regulation Plan. In the alternative, McLeod state that such issues should be addressed “in the proceeding relating to Condition 30 of the order approving the SBC-Ameritech merger, Docket 01-0120, or another docket that is focused on this specific topic.”

The Company urges the Commission to adopt McLeod’s alternative proposal and should address wholesale issues in another, more appropriate forum. First, as McLeodUSA noted, Docket 01-0120 is already underway, with the express purpose of addressing Merger Condition 30. Second, Ameritech Illinois noted that wholesale service quality can be addressed in a variety of proceedings far more appropriate to that purpose, including the negotiation and arbitration process, rulemaking proceedings and others. Third, the record in this proceeding contains very little evidence concerning the measures, benchmarks, and remedies most appropriate for carriers.

Commission Analysis and Conclusion

We see no good reason to further expand the scope of this docket. The Commission will adopt McLeod’s proposal that we address issues concerning wholesale service quality in Docket 01-0120. Issues concerning wholesale service quality can also be addressed in a wide variety of other proceedings, as Ameritech Illinois observed. The record in this proceeding is simply inadequate to address, in any meaningful way, the issues of wholesale service quality.

VIII. FINDINGS AND ORDERING PARAGRAPHS

The Commission, having considered the entire record herein and being fully advised in the premises, is of the opinion and finds that:

(1) Illinois Bell Telephone Company d/b/a Ameritech Illinois (“Ameritech”, “AI” or the “Company”)is an Illinois corporation engaged in the business of providing telecommunications services to the public in the State of Illinois and, as such, is a telecommunications carrier within the meaning of Section 13-202 of the Illinois Public Utilities Act (“Act”);

(2) the Commission has jurisdiction over the parties and the subject matter of this proceeding pursuant to the Illinois Public Utilities Act;

(3) the recitals of fact and conclusions of law reached in the prefatory portion of this Final Order are supported by the evidence in the record and the law and hereby adopted as findings of fact and law;

(4) Ameritech’s petition for rate re-balancing in Docket 98-0335, is denied;

(5) the CUB/AG complaint in Docket 00-0764, is denied;

(6) the findings of fact and conclusions of law set forth in the prefatory portion of this Order are supported by the record and are hereby adopted as findings of facts and conclusions of law for purpose of this Order;

(7) the terms and conditions contained herein, to the extent they modify or conflict with the original terms and conditions as set forth in the Alternative Regulation Plan as approved in Docket 92-0448/93-0239, shall be controlling. In all other respects the Alternative Regulation Plan shall remain in full force and effect;

(8) the materials submitted by the parties in this proceeding on a propriety basis and for which propriety treatment was requested are hereby considered propriety and shall continue to be accorded proprietary treatment;

(9) any petition, objections, and motions in this docket that have not been specifically disposed of should be disposed of in a manner consistent with our conclusions herein.

IT IS FURTHER ORDERED that the terms and conditions contained herein, to the extent they modify or conflict with the original terms and conditions as set forth in the Alternative Regulation Plan as approved in Docket 92-0448/93-0239, shall be controlling. In all other respects the Alternative Regulation Plan shall remain in full force and effect.

IT IS FURTHER ORDERED that Ameritech's petition for rate re-balancing in Docket 98-0355,is denied.

IT IS FURTHER ORDERED that the CUB/AG complaint in 00-0764 is denied.

IT IS FURTHER ORDERED that any objections, motions or petitions not previously disposed of are hereby disposed of consistent with the findings of this Order.

IT IS FURTHER ORDERED that subject to the provisions of Section 10-113 of the Public Utilities Act and 83 Ill. Adm. Code 200.880, this Order is not final; it is not subject to the Administrative Review law.

DATED:	May 22, 2001
BRIEFS ON EXCEPTION DUE:	June 6, 2001
REPLY ON EXCEPTION DUE:	June 13, 2001

Eve Moran/Phillip Casey,
Hearing Examiners'